**KazMunaiGas Exploration Production**

# Annual report for the year 2006.

## (materials for the Annual General Meeting on 18 May 2007)

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БАРЛАУ ӨНДІРУ АКЦИОНЕРЛІК ҚОҒАМЫ

# Corporate governance information

As an overseas company with GDRs admitted to the Official List, the Company is not required to comply with the provisions of the UK Combined Code on Corporate Governance ("Combined Code"). In addition, it is not required to disclose in its annual report whether or not it complies with the corporate governance regime of the Republic of Kazakhstan and the significant ways in which its actual governance practices differ from those set out in the Combined Code. However, the Directors consider corporate governance to be very important and support high standards of corporate governance.

## Directors' Responsibility Statement

The Directors are responsible for preparing the Annual Report and the financial statements in accordance with applicable Kazakhstan law and those International Financial Reporting Standards (IFRS) adopted by the European Union.

The Directors are required to prepare financial statements for each financial year which present a true and fair view of the financial position of the Company and the financial performance and cash flows of the Company for that period. In preparing those financial statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information;
- provide additional disclosures when compliance with the specific requirements in IFRS is insufficient to enable users to un derstand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance; and
- state that the Company has complied with IFRS, subject to an material departures disclosed and explained in the financial statements.

The Directors are responsible for keeping accounting records which disclose with reasonable accuracy at any time the financial position of the Company and enable them to ensure that the financial statements comply with the requirements of Kazakhstan law, the UKLA's Disclosure and Transparency Rules and the Company's Corporate Governance Code. They are also responsible for safeguarding the assets of the Company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

Each of the Directors, whose names appear on pages 28-29 of this Annual Report, confirms that to the best of his or her knowledge:

a) the financial statements, prepared in accordance with IFRS, give a true and fair view of the assets, liabilities, financial position and profit or loss of the Company; and
b) the management report includes a fair review of the development and performance of the business and the position of the Company, together with a description of the principal risks and uncertainties that they face.

## Corporate Governance

Corporate governance best practice in Kazakhstan is set out in the Kazakhstan Corporate Management Code. The Kazakhstan Corporate Management Code is based on existing international best practice in the area of corporate governance and sets out recommendations for applying the principles of corporate governance by Kazakhstan joint-stock companies. It was approved by the Expert Council for Securities Market Matters under the National Bank of the Republic of Kazakhstan in September 2002. The Company currently complies with the provisions of the Kazakhstan Corporate Management Code in all material respects.

The Company has adopted the Kazakhstan Corporate Management Code, modified to include certain provisions from the Combined Code, as its Corporate Governance Code. The modifications adopted by the Company impose additional corporate governance obligations on the Company and include certain requirements that are set out in the Combined Code. The Company believes that these additional modifications significantly strengthen the corporate governance regime adopted by the Company. The Company will also take into consideration the terms of the Combined Code and will seek to improve its standards of corporate governance in the future.

The Combined Code provides that the board of directors of a UK listed company should include a balance of executive and non-executive directors, with non-executive directors comprising at least one-half of the board of directors (excluding the Chairman). The Combined Code states that the board of directors should determine whether a director is independent in character and judgment and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director's judgment.

The Company currently operates with two boards, the Board of Directors (the supervisory body) and a separate Management Board (the executive body). The General Director, who heads the Management Board, is also a director of the Company. The Board of Directors therefore only contains one executive member of the Company's management. The Company currently has three Independent Non-Executive Directors, being Christopher Mackenzie, Paul Manduca and Edward Walshe. The Independent Non-Executive Directors work closely with the other directors and the Management Board to ensure that the Company complies with its corporate governance obligations. Under the terms of the Company's Corporate Governance Code, the Company uses the same standards set out in the Combined Code to determine the independence of its directors. The Company's Management Board comprises senior executives of the Company, including its General Director (CEO) and Chief Financial Officer (CFO).

The Directors have adopted terms of reference for and have formed an audit committee (28 November 2006), a nominations committee (1 September 2006) and a remuneration committee (1 September 2006). All the members of the Audit Committee and Remuneration Committee and a majority of the members of the Nominations Committee are Independent Non-Executive Directors.

## The Board of Directors Structure

As at 31 December 2006, the Board comprised eight members, being the Chairman (Non-Executive Director), Uzakbai Karabalin, the General Director and CEO, Askar Balzhanov and six Non-Executive directors. Since 1 January 2006, the Board has implemented a number of changes to the way the Company is directed and controlled. The following changes in the composition of the Board of Director of KazMunaiGas EP JSC during 2006 were made based on decisions of general meetings of shareholders upon proposals from representatives of shareholders:

- on 27 February 2006 N.K. Rakhmetov was removed as a direc tor and D.R. Abulgazin was elected;
- on 12 June 2006 M.D. Batyrbaev, G.K. Keshubaev, K.B. Safinov were removed as directors and E.A.Zhangaulov, E.K. Ogai, A.K. Balzhanov were elected;
- on 4 July 2006 of D.R. Abulgazin was removed as a director and A. Syrgabekova was elected;
- n 28 August 2006 Paul Manduca, Christopher Mackenzie, Ed ward Thomas Walsh were elected as independent members of the Board of Directors; and
- on 24 November 2006 Zh. Marabayev was removed as a direc tor and U.S. Karabalin was elected.

Members of the Board of Directors as of 31 December 2006:

| Name | Position with the Company |
|---|---|
| Uzakbai Karabalin | Chairman and Non-Executive Director |
| Askar Balzhanov | General Director, CEO |
| Assia Syrgabekova | Non-Executive Director |
| Erzhan Zhangaulov | Non-Executive Director |
| Evgueni Ogai | Non-Executive Director |
| Christopher Mackenzie | Independent Non-Executive Director |
| Edward Walshe | Independent Non-Executive Director |
| Paul Manduca | Independent Non-Executive Director |

In accordance with the provisions of the Corporate Governance Code, consideration has been given to the independence of all the non-executive directors. The Board considers Mr Mackenzie, Mr Walsh and Mr Manduca to be independent of management and free from any business or other relationship that could materially interfere with the exercise of independent judgment.

## The Management Board Structure

During 2006 subject to resolutions of the Board of Directors of KazMunaiGas EP JSC the composition of the Management Board of the Company has been amended as follows:

- on 7 June 2006 the powers of Zh. Marabayev were terminated, A.K. Balzhanov was elected; and
- on 25 August 2006 the powers of T.V. Palamar were terminated, A. Aubakirov was elected.

Members of the Management Board as of 31 December 2006 were:

| Name | Position with the Company |
|---|---|
| Askar Balzhanov | General Director, CEO |
| Vladimir Miroshnikov | First Deputy of General Director |
| Zhanneta Bekezhanova | Deputy General Director, CFO |
| Askar Aubakirov | Deputy General Director, Corporate Development |
| Kairolla Erezhepov | Managing Director on Human Resources and Information Policy |
| Murat Kurbanbayev | Head of UMG |
| Maxim Izbasov | Director of EMG |

During January 2007 subject to resolutions of the Board of Directors of KazMunaiGas EP JSC the composition of the Management Board of the Company has been amended as follows:

- on 08 January 2007 the powers of M.S. Izbasov were terminated, B.L. Biseken was elected.

## The Board of Directors and the Management Board Responsibilities

The Board of Directors is responsible to shareholders for the effective and proper management and control of the Company and has a formal schedule of matters reserved for its decisions. Its primary roles are to determine and review the Company's strategy and policy, consider acquisitions and give consideration to all other significant financial matters. This process is undertaken following discussions in conjunction with Management Board which in turn is responsible for the day to day conduct of the Company's operations and for reporting to the Board of Directors on the progress being made in meeting the objectives of the Company. The Board of Directors holds meetings on a regular basis and additionally for specific purposes as and when required.

During 2006 there were 34 meetings of the Board of Directors including 8 meetings by voting in presence, 2 meetings in the form of voting in presence by conference-call and 24 meetings by written resolution. During 2006, as part of its formal business the Directors adopted terms of reference for and formed an audit committee, a nominations committee and a remuneration committee. In addition the Board conducted a review of the Group's system of internal controls and approved the Guidance for internal audit of the Company and Internal Audit Service work schedule for 2006.

Implementing the Company's strategies of acquisition and rationalisation of operations the Board also discussed and approved the Assets Restructuring Program of the Company for 2006-2008 and the Company's new edition of Rules on disposal of assets.

The Management Board holds meetings on a regular basis and additionally for specific purposes as and when required. During 2006 there were 48 meetings of the Management Board, including 9 meetings by voting in presence and 39 held by written resolution. The following important issues were among those considered by the Management Board: cost of transporting and processing,, price of crude oil and oil products, annual plan of purchase of goods and services, approval of condensed consolidated interim financial statements of the Company and human resource and management related issues..

## Audit Committee

This Committee is staffed exclusively by the Independent Non-Executive Directors being Mr Manduca, Mr Mackenzie and Mr Walshe, and it is chaired by Mr Manduca. It is for the Audit Committee Chairman to decide the frequency and timing of Audit Committee meetings. There are as many meetings as the Audit Committee's role and responsibilities require. However, there are no less than four meetings during the year, held to coincide with key dates within the Company's financial reporting and audit cycle (when the audit plans, internal and external, are available for review and when interim financial statements, preliminary announcements and the full annual report are near completion). Appointments to the Audit Committee are for a period of up to three years, extendable by no more than two additional three-year periods by resolution of the Board of Directors, so long as the members continue to be independent.

The Audit Committee has responsibility, for amongst other things, to review and challenge the Company's annual and interim reports. It also has the benefit of the services of the Company's Internal Audit Service, which reviews the Company's internal controls. The Committee focuses in particular on compliance with legal requirements, accounting standards, the applicable rules of the UKLA and the KASE and on ensuring that an effective system of internal financial control is maintained. The ultimate responsibility for reviewing and approving the annual and interim report and accounts remains with the Board of Directors.

The duties of the Audit Committee covered in the terms of reference are: financial reporting, internal controls and risk management systems, whistle blowing, internal audit, external audit, and reporting responsibilities. The terms of reference also set out the authority of the Committee to exercise its duties.

The Audit Committee, where practicable, periodically reviews certain major acquisition and disposal transactions and deals with any matters which the Board may refer to the Audit Committee.

The Chairman of the Audit Committee is presented at the shareholders general meeting to answer questions, through the Chairman of the Board, on the report on the Audit Committee's activities and matters within the scope of the Audit Committee's responsibilities.

In 2006 the Audit Committee was involved in the preparation of IFRS financial statements and the approval of quarter and annual reports applied to KASE and LSE. The Audit Committee was responsible for procedures related to the Company's Internal Audit Service and monitored the processes of addressing material weaknesses in the Company's internal controls identified by the external auditor Ernst & Young Kazakhstan LLP.

## Remuneration Committee

TThe Remuneration Committee normally meets not less than twice a year. This Committee is staffed exclusively by the Independent Non-Executive Directors. It is chaired by Mr Mackenzie and its other members are Mr Manduca and Mr Walshe. The Remuneration Committee has responsibility for making recommendations to the Board of Directors on the Company's policy on the remuneration of certain senior executives (including the Management Board), the implementation and operation of share incentive schemes and for the determination, within agreed terms of reference, of specific remuneration packages for each of the members of the Management Board, including pension rights, contracts of employment and any compensation payments. In addition to making recommendations on remuneration and share packages, the remuneration committee maintains reports for corporate governance purposes.

The terms of reference of the Remuneration Committee cover such issues as membership and frequency of meetings, as mentioned above, the requirements of notice of and quorum for and the right to attend meetings. The duties of the Remuneration Committee covered in the terms of reference relate to the following: determining and monitoring policy on and setting arrangements, authorising claims for expenses from the General Director and Chairman and reporting and disclosure. The terms of reference also set out the reporting responsibilities and the authority of the Committee to exercise its duties.

From the date of its establishment the Remuneration Committee has developed the recommendations to the Board of Directors for two types of options schemes: ordinary option scheme for the employees' motivation and a special option for participation in the IPO process.

## Nominations Committee

The Nominations Committee meets not less than twice a year. The majority of members of the Nominations Committee are Independent Non-Executive Directors, with the remaining member being the General Director. It is chaired by Mr Balzhanov and its other members are Mr Mackenzie and Mr Walshe. The Nominations Committee considers the composition of the Board of Directors, retirements and appointments of additional and replacement directors and makes appropriate recommendations to the Board of Directors.

# Directors', senior executives' and others' interests

## Directors' and members of the Management Board's interests

The interests of the Directors and the members of the Management Board in the ordinary shares and preference shares of the Company all of which are beneficial unless otherwise stated are as follows (as at 31 Desember 2006):

| Name | Number of Ordinary Shares | Number of Preference Shares |
|---|---|---|
| Christopher Mackenzie | 1,166 | — |
| Paul Manduca | 1,138 | — |
| Edward Walshe | 1,138 | — |
| Assia Syrgabekova | 796 | — |
| Askar Aubakirov | 565 | 34 |
| Zhanneta Bekezhanova | 474 | — |
| Vladimir Miroshnikov | 401 | — |
| Murat Kurbanbayev | 401 | 1,236 |
| Maxim Izbasov* | — | 510 |

* On 08 January 2007 the powers of Maxim Izbasov were terminated, Bagitkali Biseken was elected. Bagitkali Biseken owns an interest in the amount of 280 preference shares.

The Directors and members of the Management Board as Shareholders have the same voting rights as all other Shareholders.

Options over GDRs have been granted to Directors and members of the Management Board as follows (as at 31 Desember 2006):

| Name | Name of Scheme | Number of GDRs over which options granted | Exercise price | Dates exercisable between |
|---|---|---|---|---|
| Askar Balzhanov | Company's Share Option Plan | 36,916 | US$14.64 | One-third on each of 4 October 2007, 2008 and 2009 |
| | | 10,662 | Nil | 29 December 2007 |
| Vladimir Miroshnikov | Company's Share Option Plan | 33,844 | US$14.64 | One-third on each of 4 October 2007, 2008 and 2009 |
| | | 9,935 | Nil | 29 December 2007 |
| Zhanneta Bekezhanova | Company's Share Option Plan | 29,262 | US$14.64 | One-third on each of 4 October 2007, 2008 and 2009 |
| | | 8,590 | Nil | 29 December 2007 |
| Kairolla Erezhepov. | Company's Share Option Plan | 22,025 | US$14.64 | One-third on each of 4 October 2007, 2008 and 2009 |
| | | 6,465 | Nil | 29 December 2007 |
| Murat Kurbanbayev. | Company's Share Option Plan | 27,044 | US$14.64 | One-third on each of 4 October 2007, 2008 and 2009 |
| | | 7,938 | Nil | 29 December 2007 |
| Askar Aubakirov | Company's Share Option Plan | 27,044 | US$14.64 | One-third on each of 4 October 2007, 2008 and 2009 |
| | | 7,938 | Nil | 29 December 2007 |

## Principal Shareholders and/or GDR Holders

In so far as is known to the Company, the name of each person who, directly or indirectly, has an interest in the ordinary shares or GDRs which is notifiable under Kazakhstan law, and the amount of such person's interest as of 31 December 2006 are as follows:

| Shareholder | Number of Ordinary Shares | Number of Preferred Shares | Total Share Capital |
|---|---|---|---|
| Total number of shares issued(1) | 70,220,935 | 4,136,107 | 74,357,042 |
| Held by JSC NC KazMunaiGas(2) | 42,213,429 | - | 42,213,429 |
| Percentage of issued share capital | 60.12% | 0.00% | 56.77% |

(1) Including 341,530 of treasury stock.
(2) As of the date of publishing the Annual Report: 43,087,006 common shares or 61.36% held by JSC NC KazMunaiGas.

## Service agreements and letters of appointment

Directors' Service Contracts
Uzakbai Karabalin is engaged by the Company as a non-executive Director and Chairman. He was appointed Director at an extraordinary general meeting of the Shareholders on 24 November 2006. On 28 November 2006, the Board of Directors of the Company elected Mr. Karabalin as Chairman. Mr. Karabalin will not receive any fee in respect of his role as a Director of the Company but will be entitled to reimbursement for costs and expenses associated with such appointment.

Askar Balzhanov is engaged by the Company as an executive Director and CEO of the Company. He was appointed CEO on 7 June 2006 and appointed a Director at a general meeting of the Shareholders held on 12 June 2006. Mr. Balzhanov will not receive any fee in respect of his role as a Director of the Company but will be entitled to reimbursement for costs and expenses associated with such appointment.

Yerzhan Zhangaulov is engaged by the Company as a non-executive Director. He was appointed Director at a general Shareholders meeting of the Shareholders held on 12 June 2006. Mr. Zhangaulov will not receive any fee in respect of his role as a Director of the Company but will be entitled to reimbursement for costs and expenses associated with such appointment.

Evgueni Ogai is engaged by the Company as a non-executive Director. He was appointed Director at a general meeting of the Shareholders held on 12 June 2006. Dr Ogai will not receive any fee in respect of his role as a Director of the Company but will be entitled to reimbursement for costs and expenses associated with such appointment.

Assia Syrgabekova is engaged by the Company as a non-executive Director. She was appointed Director at a general meeting of the Shareholders held on 4 July 2006. Ms Syrgabekova will not receive any fee in respect of her role as a Director of the Company but will be entitled to reimbursement for costs and expenses associated with such appointment.

Christopher Mackenzie is engaged by the Company as a Non-Executive Director on the terms of a letter of appointment and decision of a general meeting of the Shareholders dated 28 August 2006. Under the letter of appointment, Mr. Mackenzie is entitled to an annual fee of US$100,000, a fee of US$10,000 for each meeting of the Board of Directors that he physically attends (US$5,000 if attended by telephone or video conference), a fee of US$2,500 for each separate meeting of the Independent Non-Executive Directors that he attends and an annual fee of US$15,000 in respect of his duties as chairman of the Remuneration Committee of the Board of Directors. The letter of appointment may be terminated by either the Company or Mr. Mackenzie on three months' notice, although it is anticipated that the appointment will initially be for 24 months from the date of appointment.

Paul Manduca is engaged by the Company as a Non-Executive Director on the terms of a letter of appointment and decision of a general meeting of the Shareholders dated 28 August 2006. Under the letter of appointment, Mr. Manduca is entitled to an annual fee of US$100,000, a fee of US$10,000 for each meeting of the Board of Directors that he physically attends (US$5,000 if attended by telephone or video conference), a fee of US$2,500 for each separate meeting of the Independent Non-Executive Directors that he attends and an annual fee of US$25,000 in respect of his duties as chairman of the Audit Committee of the Board of Directors. The letter of appointment may be terminated by either the Company or Mr. Manduca on three months' notice, although it is anticipated that the appointment will initially be for 24 months from the date of appointment.

Edward Walshe is engaged by the Company as a non-executive Director on the terms of a letter of appointment and decision of a general meeting of the Shareholders dated 28 August 2006. Under the letter of appointment, Mr. Walshe is entitled to an annual fee of US$100,000, a fee of US$10,000 for each meeting of the Board of Directors that he physically attends (US$5,000 if attended by telephone or video conference) and a fee of US$2,500 for each separate meeting of the Independent Non-Executive Directors that he attends. The letter of appointment may be terminated by either the Company or Mr. Walshe on three months' notice, although it is anticipated that the appointment will initially be for 24 months from the date of appointment.

*Other*
All members of the Management Board have entered into service contracts with the Company which generally provide for business travel insurance, for reimbursement for expenses incurred while travelling on the Company business in accordance with the internal rules of the Company, and for a car and driver. Save as set out above, there are no existing or proposed service contracts between the Directors or members of the Management Board of the Company.

The aggregate remuneration paid to the members of the Board of Directors and Management Board for the year ended 31 December 2006 (including any contingent or deferred compensation) and benefits in kind granted to the members of the Board of Directors and Management Board by the Company was KZT605 million.

At 31 December 2006 there were no benefits set aside or accrued by the Company to provide pension, retirement or similar benefits to the Directors or members of the Management Board.

# United Kingdom tax considerations

The comments below are of a general nature and are based on current United Kingdom law and HM Revenue & Customs practice at the date of this document, both of which are subject to change, possibly with retrospective effect. Except as otherwise stated, the summary only discusses certain UK tax consequences of holding the shares or the GDRs for the absolute beneficial owners of the shares or the GDRs (1) who are resident or ordinarily resident in the UK for tax purposes; (2) who are not resident for tax purposes in any other jurisdiction; and (3) who do not have a permanent establishment or fixed base in Kazakhstan with which the holding of the shares or the GDRs is connected ("UK holders"). In addition, the summary (1) only addresses the tax consequences for UK holders who hold the shares and the GDRs as capital assets, and does not address the tax consequences which may be relevant to certain other categories of UK holders, for example, dealers; (2) assumes that the UK holder does not either directly or indirectly control 10% or more of the voting power of the company; (3) assumes that a holder of the GDRs is beneficially entitled to the underlying shares and to the dividends on those shares; and (4) does not address the tax consequences of UK holders that are insurance companies, collective investment schemes or pensions connected with the Company.

The following is intended only as a general guide and is not intended to be, nor should it be considered to be, legal or tax advice to any particular UK holder. Accordingly, potential investors should satisfy themselves as to the overall tax consequences, including, specifically, the consequences under UK law and HM Revenue & Customs practice, of the acquisition, ownership and disposal of the shares or the GDRs in their own particular circumstances, by consulting their own tax advisers.

*Withholding tax*

Assuming that the income received under the GDRs does not have a United Kingdom source, there should be no United Kingdom withholding tax on payment of any such income. Dividend payments in respect of the shares will not be subject to UK withholding tax.

*Taxation of Dividends*

A UK holder that receives a dividend on the shares or the GDRs may be subject to UK income tax or corporation tax as the case may be, on the gross amount of any dividend paid before the deduction of any Kazakhstan withholding taxes, subject to the availability of any credit for Kazakhstan tax withheld. A UK holder who is an individual resident and domiciled in the UK will generally be subject to UK income tax on the dividend paid on the shares or the GDRs. A UK holder who is an individual resident but not domiciled in the UK will generally be subject to UK income tax on the dividend paid on the shares or the GDRs to the extent that the dividend is remitted, or treated as remitted, to the UK. A corporate UK holder will generally be subject to UK corporation tax on the dividend paid on the shares or the GDRs. A corporate holder of the shares or the GDRs that is not resident in the UK will generally be subject to UK corporation tax on the dividend paid on the shares or the GDRs where the shares or the GDRs in question are attributable to a trade carried on by the holder in the UK through a permanent establishment.

*Taxation of Disposals or deemed Disposals*

The disposal by a UK holder of interests in the shares or the GDRs may give rise to a chargeable gain or allowable loss for the purposes of UK taxation of chargeable gains, depending on the UK holder's circumstances and subject to any available exemption or relief. A UK holder who is an individual and domiciled in the UK will generally be liable to UK capital gains tax on chargeable gains made on the disposal of an interest in the shares or the GDRs. A UK holder who is an individual but not domiciled, in the UK will generally be liable to UK capital gains tax to the extent that the chargeable gains made on the disposal of an interest in the shares or the GDRs are remitted or treated as remitted to the UK. In particular, dealings in the GDRs on the London Stock Exchange may give rise to remitted profits that would, therefore, give rise to UK capital gains tax liability.

An individual holder of the shares or the GDRs who ceases to be resident or ordinarily resident in the UK for UK tax purposes for a period of less than five years and who disposes of such shares or GDRs during that period may also be liable on returning to the UK for UK tax on capital gains despite the fact that the individual may not be resident or ordinarily resident in the UK for UK tax purposes at the time of the disposal. A corporate UK holder will generally be subject to UK corporation tax on any chargeable gain arising from a disposal of the shares or the GDRs.

*Effect of Kazakhstan withholding taxes*

Dividend payments in respect of the shares and the GDRs will be subject to Kazakhstan withholding taxes. A UK holder should generally be entitled to a credit for Kazakhstan tax properly withheld from such payments against such investor's liability to income tax or corporation tax on such amounts, subject to UK tax rules for calculation of such a credit.

*Stamp duty and stamp duty reserve tax ("SDRT")*

Assuming that any document effecting a transfer of, or containing an agreement to transfer, one or more of the shares or the GDRs is neither (i) executed in the UK nor (ii) relates to any property situate, or to any matter or thing done or to be done, in the UK (which may include involvement of UK bank accounts in payment mechanics), then no UK ad valorem stamp duty should be payable on such a document.

Even if a document effecting a transfer of, or containing an agreement to transfer, one or more of the shares or the GDRs is (i) executed in the UK and/or (ii) relates to any property situate, or to any matter or thing done or to be done, in the UK, in practice it should not be necessary to pay any UK ad valorem stamp duty on such a document unless the document is required for any purposes in the UK. If it is necessary to pay UK ad valorem stamp duty, it may also be necessary to pay interest and penalties.

As the GDRs relate to stock expressed in a currency other than sterling, no "bearer instrument" stamp duty should be payable on either the issue of the GDRs or any transfer of stock transferable by means of the GDRs.

Assuming that the shares are neither (i) registered in a register kept in the UK nor (ii) paired with shares issued by a company incorporated in the UK, no SDRT should be payable in respect of any agreement to transfer the shares or the GDRs.

# Operating and financial review

The following document is intended to assist in the understanding and assessment of the trends and significant changes in the Company's results of operations and financial condition.

This document was published on 19.03.2007

## Operational activity in 2006

JSC KazMunaiGas Exploration Production (hereinafter – the Company) conducts its production activities at 44 oil and gas fields including production branch JSC Uzenmunaigas (hereinafter – UMG) – 7 fields, production branch JSC EmbamunaiGas (hereinafter – EMG) – 37 fields.

The Company achieved its targeted production goals for 2006 with oil production of 9.53 million tonnes which was 102% of 2005 oil production. Of this total oil production 6.73 million tonnes were produced by UMG and 2.80 thousand tonnes by EMG.

### Crude oil production, million tonnes

| Production branch | 2006 | 2005 | % |
|---|---|---|---|
| Uzenmunaigas | 6.73 | 6.55 | 103% |
| Embamunaigas | 2.80 | 2.79 | 100% |
| Total | 9.53 | 9.34 | 102% |

As at 01 January, 2007 the Company had 5,865 production wells and 1,693 injection wells. During 2006 the share of idle wells decreased to 1.7%, compared to 2.0% a year before.

The majority of the Company's existing oil fields are at the mature stage of development, characterised by high watercut and decline of oil production. The Company performed production drilling, workover operations, enhanced recovery and sidetrack drilling in order to mitigate natural production decline and maintain planned volume of oil production in 2006.

In 2006 the Company constructed 221 wells which contributed 279,700 tonnes to production. Workovers were conducted on 1,361 wells and provided an incremental production of 558,000 tonnes. Sidetrack drilling operations were performed on 16 wells resulting in an incremental production of 17,100 tonnes. The Company applied enhanced recovery techniques, including hydro-fracturing and various chemical and thermal methods. As a result an additional 616,800 tonnes were recovered following 775 well operations.

In 2006 the Company conducted exploration activities on the following blocks/fields:

- Greenfield exploration – Taisoigan (Uas, Kondybai), R-9 (Koikara, Duiseke North, Akingen, Kulsary NW) and territories adjacent to the Uzen and Karamandybas fields.
- Supplementary exploration – S. Nurzhanov, Akingen (south wing), Prorva West, Uzen (Pasmurun East) and Karamandybas.

During the year 10 exploration wells were drilled. The following wells were productive: Kondybai 8, Uas15, 16, Nurzhanov 501, Akingen1-A and Uzen-6244.

The seismic field surveys were performed at 2,100 running km/ 70 square km. Infrasonic passive differential spectroscopy ("IPDS") works were conducted on the Nurzhanov and Kenbay fields. Seismic survey on the Liman and R-9 blocks provided encouraging data including the identification of positive raises of post-salt structures at the depth of 4,800 - 5,100 meters.

# Planned operational activity in 2007

Crude oil production in 2007 is expected to reach 9.5 million tonnes, approximately the same level as in 2006. In order to offset the natural production decline the Company is planning to drill 175 production wells in 2007 as well as perform operations on the existing wells, including reservoir recovery improvements, well work-overs, bottomhole zone treatment and the rehabilitation of previously abandoned wells.

For 2007, the Company is planning increased exploration activities in prospective blocks focusing on identification of geological structures and drilling candidates. In particular, the Company is planning exploration works on the R-9, Taisoigan and Liman blocks and on territories adjacent to the Uzen and Karamandybas fields. In addition, supplementary exploration works on the S. Nurzhanov, Uzen-Karamandybas and Akingen fields are planned.

The Company's capital expenditures in 2007, calculated on a cash basis, are expected to be KZT39.8 billion.

# Business Environment and Outlook

Economic factors affecting the Company's financial performance during the year under review include movements in crude oil prices, foreign exchange, particularly the Tenge-US dollar rate, and domestic inflation rates.

Crude oil sales are the Company's primary source of revenue. The Company's business, prospects, financial condition and results of operations are heavily dependent on prevailing crude oil prices. Historically, crude oil prices have been highly volatile. The Company's revenues and net income fluctuate significantly with changes in crude oil prices. Although oil prices worldwide have increased significantly since 2001, there can be no assurance that such growth, or the existing level of oil prices, will be maintained in the future. Any future declines (even relatively modest declines) in oil prices could adversely affect the Company's business, prospects, financial condition and results of operations.

## Business Environment in 2006

The price for Brent averaged US$ 65.14 per barrel in 2006, an increase of almost US$12 per barrel from 2005 average price.

| | Year ended 31 December | |
|---|---|---|
| Average for the year indicated | 2006 (US$ /bbl) | 2005 (US$ /bbl) |
| Brent | 65.14 | 54.38 |
| CPC blend | 65.23 | 53.50 |
| Urals | 60.99 | 50.52 |

Source: Bloomberg, Platts

Most of the Company's revenues and borrowings are denominated in US dollars, while most of the Company's operating expenses are denominated in Tenge. The impact of foreign currency fluctuations on the Company's results of operations depends on the Company's net foreign currency position and the magnitude and direction of the fluctuation.

Tenge-US dollar exchange rates and domestic inflation, as measured by the consumer price index ("CPI") for the periods presented were as follows:

| | Year ended 31 December | |
|---|---|---|
| Average for the year indicated | 2006 (US$ /bbl) | 2005 (US$ /bbl) |
| Tenge—US$ average exchange rate | 126.09 | 132.88 |
| CPI | 8.4% | 7.6% |

Source: National Bank of Kazakhstan

In 2006 the Tenge has strengthened against the US dollar from 132.88 Tenge/US$ in 2005 to 126.09 Tenge/US$ in 2006. The CPI has reached the level of 8.4% in 2006, compared with 7.6% in 2005. The appreciation of the Tenge during 2006 has tended to dampen the positive effect of higher crude oil prices and depress the Company's revenue expressed in Tenge. In addition, most of the Company's expenses are affected by the increased local inflation rate which may not be offset by inflation related increases in the Company's revenues.

## Outlook for Business Environment in 2007

After falling approximately by US$10 per barrel from the beginning of 2007, and almost touching the level of US$50 per barrel, the Brent price has since rebounded and spent February trading at about the level of US$60 per barrel. Prices for crude oil are expected to remain volatile in 2007 in response to a variety of factors.

During the first two months of 2007 the Tenge continued strengthening against the US dollar and averaged 125.27 Tenge/US$ for the period, an appreciation of more than 0.82 Tenge above 2006 average rate of 126.09 Tenge/US$. Based on the Government's forecast, the Tenge/US$ exchange rate is expected to continue its declining trend.

The CPI increased by 1.1% and 1.9% for January and February 2007, compared to 0.9% and 2.4% for the related months of 2006. The National Bank of Kazakhstan forecasts CPI for 2007 within the range from 7.3% to 8.3% or slightly lower than the actual 8.4% in 2006.

The Company does not expect significant changes in such aspects of the Company's business environment as transportation tariffs and route capacities, availability of production, finance and human resources.

# Results of Operations

Amounts shown in US dollars have been translated solely for the convenience of the reader at the average rate over the applicable year for information derived from the consolidated statements of income and consolidated statements of cash flows and the end of the year rate for information derived from the consolidated balance sheets. See "Business Environment and Outlook".

| | | | | Year ended 31 December |
|---|---|---|---|---|
| | 2006 (US$ thousands) | 2006 (KZT thousands) | 2005 (US$ thousands) | 2005 (KZT thousands) |
| Revenue | 3,269,155 | 412,207,787 | ,625,586 | 348,887,820 |
| Operating expenses | 1,542,787 | 194,530,080 | 1,558,052 | 207,033,927 |
| Operating expenses (KZT/USD per bbl produced)[1] | 21.99 | 2,773 | 22.66 | 3,012 |
| Profit from operations | 1,726,367 | 217,677,707 | 1,067,534 | 141,853,893 |
| Profit for the year from continuing operations | 972,013 | 122,561,217 | 329,288 | 43,755,822 |
| Oil Production and other cost [2] | 735,415 | 92,728,483 | 685,042 | 91,028,417 |
| Oil Production and other costs (KZT/USD per bbl produced)[1][2] | 10.48 | 1,322 | 9.96 | 1,324 |
| Capital expenditure[3] | 390,876 | 49,285,538 | 365,106 | 48,515,240 |
| Net cash[4] | 1,821,812 | 231,370,078 | 47,504 | 6,354,581 |

1. Converted at 7.36 barrels per tonne of crude oil.
2. Oil production and other costs represent an aggregate of the following operating expenses line items (as presented in the Company's IFRS financial statements): employee costs, materials expense, repair, maintenance and other services, energy and other costs. These include costs related to gas producing and processing activities, oil processing activities and general and administrative costs which are not directly related to oil production and which increased the US dollar cost per barrel by approximately US$1 to US$2 for both the year ended 31 December 2006 and for the year ended 31 December 2005. Oil production and other costs exclude royalties (production tax) and all other taxes.
3. Excludes capital expenditure of discontinued operations. See "Capital Expenditures".
4. Current financial assets exclude loans receivable from NC KMG, as at 31 December 2006 and 31 December 2005 respectively, of KZT100.9 billion and KZT12.6 billion. The consolidated net cash translated at the year-end rates of 127.00 Tenge/US$ and 133.77 Tenge/US$ for 2006 and 2005 respectively.

## Continuing Operations

*Transport Routes*

The Company delivers its crude oil through three principal routes: export markets via the CPC and UAS pipelines and the domestic market, as outlined in the following table:

| | Year ended 31 December | |
|---|---|---|
| | 2006 | 2005 |
| EXPORTS VIA CPC | | |
| Volume of crude oil (in million tonnes) | 1.7 | 1.5 |
| % total crude oil sales volume | 18% | 17% |
| % total sales of oil and oil products | 23% | 22% |
| EXPORTS VIA UAS | | |
| Volume of crude oil (in million tonnes) | 5.1 | 5.0 |
| % total crude oil sales volume | 55% | 54% |
| % total sales of oil and oil products | 66% | 66% |
| OTHER[1] | | |
| Volume of crude oil (in million tonnes) | 2.5 | 2.7 |
| % total crude oil sales volume | 27% | 29% |
| % total sales of oil and oil products | 11% | 12% |

1. Until 2006, "other" is predominantly sales of refined crude oil, a small proportion of which is exported

The Company exports crude oil through the Uzen-Atyrau-Samara pipeline (hereinafter – UAS) owned by JSC KazTransOil (in Kazakhstan) and through the pipeline owned by Caspian Pipeline Consortium (hereinafter – CPC). Relative profitability of the two export routes depends on the quality of oil shipped by the Company, prevailing international market prices and applicable pipeline tariffs. Specifically, CPC tends to be more advantageous for shipments of higher quality crude oil in a higher price oil environment even after taking into account quality bank payments. Although it has been more profitable for the Company in recent periods to ship crude oil through the CPC pipeline rather than the UAS pipeline, the Ministry of Energy and Mineral Resources of Kazakhstan (hereinafter – MEMR) controls the volumes of crude oil that can be shipped through the pipelines and the Company's ability to allocate exported volume to different pipelines is therefore constrained.

*Revenue*

The following table shows sales volumes and realised prices for the years ended 31 December 2006 and 2005:

| | Year ended 31 December | |
|---|---|---|
| | 2006 | 2005 |
| | (KZT thousands, unless otherwise stated) | |
| EXPORT SALES OF CRUDE OIL | | |
| UAS pipeline | | |
| Net sales | 266,395,404 | 226,798,166 |
| Volume (in thousand tonnes) | 5,076 | 4,953 |
| Average price (KZT/tonne) | 52,487 | 45,790 |
| Average price (US$/bbl)(1) | 57.57 | 47.66 |
| CPC pipeline | | |
| Net sales | 92,991,304 | 75,690,507 |
| Volume (in thousand tonnes) | 1,663 | 1,536 |
| Average price (KZT/tonne) | 55,902 | 49,284 |
| Average price (US$/bbl)(1) | 61.32 | 51.30 |
| Total sales of crude oil-exported | 359,386,708 | 302,488,673 |
| | | |
| OTHER SALES OF CRUDE OIL AND OIL PRODUCTS | | |
| Net domestic sales of crude oil and total oil products | 44,705,552 | 40,394,425 |
| Volume (in thousand tonnes) (2) | 2,551 | 2,733 |
| Average price (KZT/tonne) | 17,525 | 14,780 |
| Average price (US$/bbl) (1) | 19.22 | 15.38 |
| Total domestic sales of crude oil and total oil product sales | 44,705,552 | |
| | | |
| TOTAL SALES OF CRUDE OIL AND OIL PRODUCTS | | |
| Total net sales of crude oil and oil products | 404,092,260 | |
| Total volume (in thousand tonnes) | 9,290 | |
| Average price (KZT/tonne) | 43,428 | |
| Average price (US$/bbl) | 46.99 | |
| Other sales | 8,115,527 | |
| Total revenue | 412,207,787 | |

1. Converted at 7.23 barrels per tonne of crude oil.

2. Volume of crude oil delivered for processing and crude oil sales.

Total volumes shipped, both export and domestic via the UAS pipeline in 2006 remained stable. At the same time export volumes via the CPC pipeline are increased. In 2006 sales of exported crude oil via the UAS pipeline increased by KZT39.6 billion, or 17.5%. The increase in sales in 2006 compared to 2005 was due to increases in both volumes and prices.

Sales of crude oil via the CPC pipeline increased by KZT17.3 billion, or 22.9%, in 2006 compared to 2005. The increase in sales for both 2006 was due to increases in both volumes and prices.

Other sales of oil and oil products increased by KZT4.3 billion, or 10.7%, in 2006. Although in 2006 the volumes of oil and oil products supplied to the domestic market were down by 182,000 tonnes, average prices were up to KZT17,525 per tonne from KZT14,780 per tonne in 2005 which resulted in an increase of sales to KZT44.7 billion from KZT40.4 billion.

The following table shows the Company's realised sales prices adjusted for oil and oil products transportation and other expenses for the years ended 31 December 2006 and 2005:

| | Year ended 31 December 2006 | | |
|---|---|---|---|
| | CPC | UAS | Other |
| | | | (US$/bbl) |
| Benchmark end-market quote [1] | 65.23 | 60.99 | - |
| Realized price (pre QB [6] and boe diff.) | 62.86 [3] | - | - |
| Net effect of QB [6] cost and boe diff. [2] | (1.54) [4] | - | - |
| Realised price | 61.32 [4] | 57.57 | 19.22 |
| Transportation | (5.93) [4] | (6.16) | (0.80) |
| Sales commissions | (0.07) [4] | (0.07) | (0.02) |
| Processing fees | - | - | (0.55) |
| Adjusted realised price | 55.32 [4] | 51.34 | 17.85 |

| | Year ended 31 December 2006 | | |
|---|---|---|---|
| | CPC | UAS | Other |
| | | | (US$/bbl) |
| Benchmark end-market quote [1] | 53.50 | 50.52 | - |
| Realized price (pre QB [6] and boe diff.) | 52.25 [3] | - | - |
| Net effect of QB [6] cost and boe diff. [5] | (0.95) [4] | - | - |
| Realised price | 51.30 [4] | 47.66 | 15.38 |
| Transportation | (5.25) [4] | (5.82) | (0.73) |
| Sales commissions | (0.07) [4] | (0.07) | (0.09) |
| Processing fees | - | - | (2.54) |
| Adjusted realised price | 45.98 [4] | 41.77 | 12.02 |

1. The following quoted prices are used as benchmarks: CPC blend (FOB Novorossiysk) for shipments through the CPC pipeline and Urals blend (FOB Odessa) for shipments through the UAS pipeline.
2. Net effect (-1.54) = QB cost (-6.41) + boe difference premium (4.87).
3. Converted at 7.79 barrels per tonne of crude oil.
4. Converted at 7.23 barrels per tonne of crude oil.
5. Net effect (-0.95) = QB cost (-5.00) + boe difference premium (4.05).
6. QB – Quality Bank monetary adjustment to compensate for difference in the quality of crude oil injected into the CPC pipeline to the CPC Blend.

The difference between the benchmark quote and realised price on the sales through the CPC pipeline mainly comprises CPC quality bank payments, port charges, customs fees, certain sales commissions and averaging effects. The difference between the benchmark quote and realised price on the sales through the UAS pipeline mainly comprises port charges, customs fees and certain sales commissions. The price received for other sales of oil and oil products is determined primarily by agreement with NC KMG and the price is significantly below market prices.

*Operating Expenses*

The Company's operating expenses relate primarily to the cost of producing crude oil. The following table presents the components of the Company's operating expenses:

| | Year ended 31 December | | | |
|---|---|---|---|---|
| | 2006 | 2005 | 2005 Adjusted [1] | Change [2] |
| | (KZT thousands, unless otherwise stated) | | | |
| Transportati on | 44,060,096 | 40,106,224 | 40,106,224 | 3,953,872 |
| Employee benefits | 37,512,548 | 37,116,032 | 36,537,043 | 975,505 |
| Depreciation, depletion and amortization | 27,758,826 | 24,362,896 | 24,083,651 | 3,675,175 |
| Repairs and maintenance | 18,988,262 | 16,845,303 | 16,637,232 | 2,351,030 |
| Royalties | 15,850,891 | 15,180,580 | 15,180,580 | 670,311 |
| Materials and supplies | 11,661,063 | 21,658,853 | 17,539,543 | (5,878,480) |
| Taxes other than on income | 9,666,804 | 7,103,491 | 7,103,491 | 2,563,313 |
| Social projects | 7,850,402 | 1,791,551 | 1,791,551 | 6,058,851 |
| Management fees and commissions | 7,678,179 | 11,976,634 | 11,976,634 | (4,298,455) |
| Energy | 6,563,701 | 5,824,741 | 5,824,741 | 738,960 |
| Fines and penalties | 363,994 | 4,056,539 | 4,056,539 | (3,692,545) |
| Environmental fine | (11,427,595) | 11,427,595 | 11,427,595 | (22,855,190) |
| Other | 18,002,909 | 9,583,488 | 9,443,041 | 8,559,868 |
| Total operating expenses | 194,530,080 | 207,033,927 | 201,707,865 | (7,177,785) |

1. Operating expenses of 2005 excluding Atyrau refinery (ANPZ)
2. Change for the year has been calculated excluding ANPZ

Operating expenses decreased in the year primarily as a result of provision reversals and the disposal of various non-core businesses in the year. The more significant amounts and movements are explained as follows (for the purposes of comparison the costs related to tolling operations in 2005 at Atyrau refinery have been excluded):

Transportation expenses for the year increased by 9% as a result of a 1% increase in the total volume of oil supplied and a higher share of exports in the supply mix.

Total costs for employee benefits for 2006 were in line with 2005, however average salaries increased by 4% and various professionals were added to the Head Office to increase the Company's capabilities in a number of areas including mergers and acquisitions, internal controls, IFRS reporting and investor relations. The above increases to employee benefits were offset by a reduction in the overall number of employees by 2% (related to non-core businesses disposed of in the year).

Depreciation, depletion and amortization increased by 13% as a result of significant capital expenditures in 2006 and 2005 and the initiation of amortization on the Liman exploration license. The average depletion rate for the company dropped to approximately 10% in 2006 from 11% in 2005, as a result of upward revisions to the Company's proved reserves.

Materials and supplies decreased significantly due to the disposal of subsidiaries involved in non-core businesses in 2006.

Management fees and commissions decreased due to the conclusion of a new Management services agreement with NC KazMunaiGaz in 2006.

At year end 2005 the Company accrued fines of KZT11.4 billion for exceeding permitted norms at certain production sites. The Government linked the fines to the delayed submission by the Company of a remediation plan in accordance with the terms of a Memorandum of Understanding signed with the Company in mid-2005. The Company has successfully appealed this amount and as a result the provision was reversed in 2006.

Other expenses increased, primarily due to the following:

- Accrual of bad debt allowance on receivables in the amount of KZT3.1 billion mainly related to receivables from Atoll and accrual of impair ment provision on investment in Atoll in the amount of KZT0.8 billion;
- ncreased use of consulting services related to improvement of busi ness processes within the Company; including the development of a management motivation program, implementation of IT procedures, improvement of financial statements process in the amount of KZT0.9 billion; and
- Write-off of obsolete property, plant and equipment in the amount of KZT0.6 billion.

*Finance Income (Expense)*

The Company's financial income in each of the periods relates mainly to interest on deposits. The Company's financial expense in each of the periods mainly comprises interest on borrowings, the unwinding of a discount relating to asset retirement obligations.

*Income Tax Expense*

Profit before tax increased by 34% to KZT217.2 billion while at the same time income tax expense decreased by KZT4.5 billion to KZT94.7 billion. The Company's overall effective tax rate in 2006 reduced to 44% from 69% in 2005 (the effective rate for 2006 was 55% when non-recurring items are excluded). The following table provides a reconciliation of the effective rate of tax to the 30% statutory rate that was in effect for both 2006 and 2005:

| | Year ended 31 December | |
|---|---|---|
| | 2006 | 2005 |
| | | (KZT thousands) |
| Profit before tax | 217,234,038 | 142,948,461 |
| Income tax | 94,672,821 | 99,192,639 |
| Effective tax rate | 44% | 69% |
| | | % of profit before tax |
| Statutory income tax | 30 | 30 |
| Increase (decrease) resulting from | | |
| Excess profit tax | 20 | 32 |
| Excess profit tax of prior years | (9) | – |
| Movement in provisions | (2) | – |
| Tax effect of items which are not deductible or assessable for taxation purposes | 5 | 7 |
| Effective tax rate | 44 | 69 |

The substantial decrease in the overall excess profit tax rate (EPT) in 2006 was a result of the Company obtaining clarification from the relevant Government authorities that the rate on the maximum EPT rate payable on its Uzen field should be calculated at 30% instead of the 50% rate which was used in prior years. The corresponding changes to the subsoil contract were applied retrospectively and have resulted in a significant amendment to the 2005 and 2004 EPT returns. The 2006 income tax expense was reduced by the reduction in prior year's EPT and the related cash flow benefit is expected to be realized by the Company in 2007 when the 2006 EPT obligation is settled. The movement in the Company's tax provisions is also primarily related to the above clarification.

The Company's non-deductible items for tax purposes relate primarily to non-core activities, as defined by the relevant hydrocarbon contracts and tax legislation, and IFRS adjustments that are not allowed for deduction in the tax legislation applicable to the Company. The Company is undergoing an extensive review of its non-deductible amounts to ensure that the proper tax treatment has been afforded to these items.

*Profit from Continuing Operations*

As a result of the factors described above, in 2006 the Company's profit from continuing operations increased by 180% to KZT122.6 billion.

## Capital Expenditures

In 2006 and 2005, the Company's capital expenditures, calculated on a cash basis and excluding Atyrau refinery disposed of in 2005, were KZT49.3 billion and KZT48.5 billion respectively. This represented 12.0% and 13.9% of sales, respectively. Annual average production capital expenditures over the years 2007 to 2010 are expected to be lower than the 2006 level as a result of the efficiency improvements being implemented by the Company.

# Liquidity and Capital Resources

## Summary of Cash Flows

The Company's liquidity requirements arise principally from the need to finance its existing operations (working capital) and the need to finance investment (capital expenditure). Management believes that the Company has adequate liquidity to meet its short-term obligations. In the years under review, the Company has been able to meet most of its liquidity needs out of net cash provided by operating activities and, to a lesser extent, out of borrowings.

| | 2006 (US$ thousands) | 2006 (KZT thousands) | 2005 (US$ thousands) | 2005 (KZT thousands) |
|---|---|---|---|---|
| Net cash generated from operating activities | 969,232 | 122,210,461 | 564,823 | 75,053,723 |
| Net cash used in investing activities | (2,366,480) | (298,389,467) | (748,769) | (99,496,430) |
| Net cash from financing activities | 1,738,914 | 219,259,624 | 226,385 | 30,082,102 |

Net cash generated from operating activities was KZT122.2 billion in 2006 compared to KZT75.1 billion in 2005. The increases were mainly a result of increases in crude oil prices.

Net cash used in investing activities was KZT298.4 billion in 2006 compared to KZT99.5 billion in 2005. The increase was primarily due to the increased holdings of held-to-maturity financial assets and an increase in loans to related parties, including NC KMG. On July 10, 2006, the Company's finance subsidiary, Munaishy Finance B.V., issued US$800 million of 6.5% fixed rate senior notes due in 2009 and loaned the proceeds from the issue to NC KMG. The repayment of the loan is scheduled for 2009 (same date as the Munaishy Finance B.V. issuance) and accrues interest at 6.6% fixed per annum.

Net cash flow from financing activities was KZT219.3 billion in 2006 compared to KZT30.1 billion in 2005. The main reason for the increase is IPO proceeds, net of transaction costs, which amounted to about KZT144.6 billion along with the proceeds from bonds issue by Munaishy Finance B. V.

## Borrowings

The following table below sets forth the Company's net cash:

| | 2006 | 2005 |
|---|---|---|
| | | (KZT thousands) |
| Current portion | 21,695,307 | 21,121,175 |
| Maturity between 1 and 2 years | 19,816,717 | 19,082,221 |
| Maturity between 2 and 5 years | 17,393,391 | 34,451,834 |
| Maturity over 5 years | 762,279 | 494,685 |
| Total borrowings | 59,667,694 | 75,149,915 |
| | | |
| Cash and cash equivalents | 62,459,415 | 20,187,588 |
| Other current financial assets [1] | 226,523,024 | 7,353,770 |
| Non-current financial assets [1] | 2,055,333 | 53,963,138 |
| Net cash | 231,370,078 | 6,354,581 |

1. Current and non-current financial assets, respectively, which comprise US dollar and Tenge denominated deposits and bonds and exclude loans receivable from NC KMG, as at 31 December 2006 and 31 December 2005 respectively, of KZT100.9 billion and KZT12.6 billion.

The Company's principle credit facilities and borrowings are described below:

*World Bank Loan.* The Uzen Rehabilitation Project has been financed by a US$109 million credit line from the World Bank granted in July 1996. The principal amount of this facility is repayable in equal installments of US$4.5 million on 15 May and 15 November of each year from November 2001 through May 2013. Interest for each semi-annual period is accrued on the outstanding principal amount at a rate equal to the cost of qualified borrowings plus 0.5%. In addition, the Company pays NC KMG a commitment charge of 0.25% per annum on the principal amount of the facility not utilised. Pursuant to a pledge agreement executed by the Ministry of Finance and the Company on 24 March 2005 the Company pledged property with the value of KZT13.6 billion to guarantee its obligations under the loan documents. The outstanding balance of this loan as at 31 December 2006 was US$44 million.

*Esomet Arrangement.* On 16 August 2004, the Company entered into a crude oil sale agreement with Esomet and received a long term advance with interest at Libor plus 1.75% per annum. To assure Esomet that payments are made, the Company has agreed to ship certain amounts of crude oil to Esomet which are sold at market prices (usually by reference to the mean quotations for Urals blend quoted on Platt's crude oil market wire) with the proceeds being used to fund the capital payments due to Esomet. The Company is obliged to deliver 150,000 tonnes of crude oil per month to Esomet until September 2009. Any surplus funds arising from the sale of the 150,000 tonnes of crude oil per month above the required capital repayments are transferred to the Company. In addition to these terms, the Company also agreed to maintain various financial ratios and significant covenants that require Esomet's prior written consent to dispose of assets, grant security or make loans that are not in the ordinary course of business in each case exceeding a specified threshold. On 12 October 2005, the Company entered into a swap transaction with Goldman Sachs International and fixed the floating interest term of the crude oil sale agreement at the rate of 4.6% per annum. On 21 December 2006 terms of the swap transaction were amended with the fixed rate gradually decreasing from 4.6% to 4.3% per annum by the end of 2007 unless Libor rate exceeds predefined trigger levels 5.4%-5.0%, in which case the rate is equal to Libor minus 20 b.p. On 24 July 2006, Esomet and the Company amended the Esomet Arrangement to include an additional payment of US$50.0 million, a reduction of the interest margin from 1.75% to 1.1% and release of the existing NC KMG guarantee. As at 31 December 2006, the Company's long-term debt to Esomet amounted to US$402 million, or KZT51.0 billion.

*Private Placement of Notes.* On 10 July 2006, the Company's finance subsidiary, Munaishy Finance B.V., issued Senior Notes due 2009 and loaned the proceeds of the issue to NC KMG for NC KMG's purchase of a 50% stake in JV Kazgermunai LLP. The Company also provided an interest-free loan to NC KMG in an amount of KZT24.4 billion (fully repaid as of 31 December 2006) to fund this acquisition and has entered into an option arrangement which gives it the right to acquire the interest in JV Kazgermunai LLP from NC KMG. The loan due to Munaishy Finance B.V. is repayable when the lender shall be obliged to repay the Senior Notes or earlier by mutual agreement of NC KMG and Munaishy Finance B.V.

# Potential Acquisitions

## JV Kazgermunai LLP

On 5 March the Company announced its agreement to acquire a 50% stake in JV Kazgermunai LLP for a cash consideration of KZT133.3 billion. On 2 March 2007 the independent non-executive directors approved the acquisition, which is subject to satisfaction of a number of conditions including the approval of a majority of independent shareholders and GDR holders at an Extraordinary General Meeting scheduled for 12 April 2007 in Astana.

Credit Suisse Securities (Europe) Limited presented to the Company's Board of Directors its fairness opinion that, subject to customary assumptions, the consideration to be paid by the Company in respect of the proposed acquisition of JV Kazgermunai LLP is fair to the Company from a financial point of view.

## OJSC PetroKazakhstan

In July 2006, NC KMG acquired a 33% stake in OJSC PetroKazakhstan for approximately US$1.4 billion. The Company is considering the possibility of acquiring these assets from NC KMG (but is under no obligation to do so). If the Company proceeds with the acquisition, necessary actions by the Company, such as full due diligence and corporate approvals including minority shareholders approval of the acquisition, will be carried prior to closing of the transaction.

## Nations Energy Company Ltd

On October 25, 2006 Nations Energy Company Ltd. (Canada) entered into an agreement with CITIC Group (China) ("CITIC") to sell to CITIC the Kazakhstan oil assets of Nations Energy for an aggregate consideration of US$1.91 billion before adjustment for cash and debt.

On December 30, 2006 NC KMG and CITIC announced that CITIC has granted to NC KMG a call option under which NC KMG may acquire a 50% interest in Nations Energy Company Ltd. The option is exercisable within one year and the price is based on acquisition price.

Currently, the Company is negotiating the transfer of the option to purchase 50 percent interest in Nations Energy Company Ltd from NC KMG to the Company.

# Risk

The detailed description of risks and uncertainties the Company is subject to was provided in the Prospectus dated 29 September 2006, issued by the Company in respect of an offering of common shares representing common shares and Global Depositary Receipts. The Directors believe that there have been no significant changes in risks and uncertainties since 29 September 2006, i.e. the date of the Prospectus preparation.

*Forward-looking statements*

*This document includes statements that are, or may be deemed to be, "forward-looking statements". These forward-looking statements can be identified by the use of forward-looking terminology, including, but not limited to, the terms "believes", "estimates", "anticipates", "expects", "intends", "may", "target", "will", or "should" or, in each case, their negative or other variations or comparable terminology, or by discussions of strategy, plans, objectives, goals, future events or intentions. These forward-looking statements include all matters that are not historical facts. They include, but are not limited to, statements regarding the Company's intentions, beliefs and statements of current expectations concerning, amongst other things, the Company's results of operations, financial condition, liquidity, prospects, growth, potential acquisitions, strategies and as to the industries in which the Company operates. By their nature, forward-looking statements involve risk and uncertainty because they relate to future events and circumstances that may or may not occur. Forward-looking statements are not guarantees of future performance and the actual results of the Company's operations, financial condition and liquidity and the development of the country and the industries in which the Company operates may differ materially from those described in, or suggested by, the forward-looking statements contained in this document. The Company does not intend, and does not assume any obligation, to update or revise any forward-looking statements or industry information set out in this document, whether as a result of new information, future events or otherwise. The Company does not make any representation, warranty or prediction that the results anticipated by such forward-looking statements will be achieved.*

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# Independent Auditors' Report

*To the shareholders of Joint Stock Company Exploration and Production KazMunaiGas*

We have audited the accompanying financial statements of Joint Stock Company Exploration and Production KazMunaiGas and its subsidiaries ("the Company"), which comprise of the balance sheet as at December 31, 2006, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

*Management's responsibility for the financial statements*

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

*Auditor's responsibility*

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

*Opinion*

In our opinion, the financial statements give a true and fair view of the financial position of the Company as of December 31, 2006, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

Ernst & Young LLP

March 12, 2007

# Consolidated Financial Statements

Joint Stock Company Exploration Production KazMunaiGas
For the year ended December 31, 2006

# Consolidated Balance Sheet

Tenge thousands unless otherwise stated

As at December 31

| | Notes | 2006 | 2005 |
|---|---|---|---|
| ASSETS | | | |
| Non-current assets | | | |
| Property, plant and equipment | 7 | 259,333,372 | 243,131,834 |
| Other financial assets | 9 | 102,841,401 | 53,963,138 |
| Intangible assets | 8 | 7,921,252 | 1,340,657 |
| Investments in associates | | 2,884,207 | 4,516,696 |
| Other assets | | 3,843,312 | 2,808,028 |
| Total non-current assets | | 376,823,544 | 305,760,353 |
| | | | |
| Current assets | | | |
| Inventories | 10 | 15,131,619 | 15,409,658 |
| Taxes prepaid and VAT recoverable | | 11,690,358 | 22,121,101 |
| Prepaid and deferred expenses | | 4,952,828 | 6,993,525 |
| Trade and other receivables | 9 | 37,356,601 | 45,918,226 |
| Other financial assets | 9 | 226,523,024 | 19,993,257 |
| Cash and cash equivalents | 9 | 62,459,415 | 20,187,588 |
| Total current assets | | 358,113,845 | 130,623,355 |
| Total assets | | 734,937,389 | 436,383,708 |
| | | | |
| EQUITY | | | |
| Share capital | 11 | 259,276,481 | 11,792,208 |
| Other equity | | 92,249 | – |
| Retained earnings | | 266,383,385 | 161,860,819 |
| Equity holders of the Company | | 525,752,115 | 173,653,027 |
| Minority interest | | 5,700 | 79,536 |
| Total equity | | 525,757,815 | 173,732,563 |
| | | | |
| LIABILITIES | | | |
| Non-current liabilities | | | |
| Borrowings | 13 | 37,972,387 | 54,028,740 |
| Deferred tax | 18 | 10,715,701 | 14,197,680 |
| Provisions | 14 | 52,155,874 | 49,701,648 |
| Total non-current liabilities | | 100,843,962 | 117,928,068 |
| | | | |
| Current liabilities | | | |
| Borrowings | 13 | 21,695,307 | 21,121,175 |
| Income taxes payable | | 25,551,751 | 46,994,090 |
| Trade and other payables | | 40,457,729 | 51,167,595 |
| Provisions | 14 | 20,630,825 | 25,440,217 |
| Total current liabilities | | 108,335,612 | 144,723,077 |
| Total liabilities | | 209,179,574 | 262,651,145 |
| Total liabilities and equity | | 734,937,389 | 436,383,708 |

The notes on pages 56 to 77 are an integral part of these consolidated financial statements

# Consolidated Statement of Income

Tenge thousands unless otherwise stated

For the year ended December 31

| | Notes | 2006 | 2005 |
|---|---|---|---|
| CONTINUING OPERATIONS | | | |
| Revenue | 15 | 412,207,787 | 348,887,820 |
| Operating expenses | 16 | (194,530,080) | (207,033,927) |
| Profit from operations | | 217,677,707 | 141,853,893 |
| | | | |
| Finance (expense) income | 17 | (115,881) | 1,381,060 |
| Share of result of associates | | (327,788) | (286,492) |
| Profit before tax | | 217,234,038 | 142,948,461 |
| | | | |
| Income tax expense | 18 | (94,672,821) | (99,192,639) |
| Profit for the year from continuing operations | | 122,561,217 | 43,755,822 |
| | | | |
| DISCONTINUED OPERATIONS | | | |
| Profit for the year from discontinued operations | 6 | – | 1,521,130 |
| Profit for the year | | 122,561,217 | 45,276,952 |
| | | | |
| Attributable to: | | | |
| Equity holders of the Company | | 122,561,334 | 45,074,642 |
| Minority interest | | (117) | 202,310 |
| | | 122,561,217 | 45,276,952 |
| | | | |
| EARNINGS PER SHARE | 12 | | |
| Attributable to equity holders of the Company | | | |
| From continuing operations – basic and diluted | | 2.26 | 0.93 |
| From discontinued operations – basic and diluted | | – | 0.03 |

The notes on pages 56 to 77 are an integral part of these consolidated financial statements

# Consolidated Statement of Cash Flows

Tenge thousands unless otherwise stated

For the year ended December 31

| | Notes | 2006 | 2005 |
|---|---|---|---|
| Cash flows from operating activities | | | |
| Receipts from customers | | 410,468,348 | 333,283,661 |
| Payments to suppliers and employees | | (160,982,545) | (181,300,015) |
| Income tax paid | | (127,275,342) | (76,929,923) |
| Net cash generated from operating activities | | 122,210,461 | 75,053,723 |
| Cash flows from investing activities | | | |
| Purchases of property, plant and equipment (PPE) | | (49,285,538) | (61,916,479) |
| Proceeds from sale of PPE | | 829,906 | 2,755,953 |
| Purchases of intangible assets | | (8,838,611) | (650,170) |
| Purchases of held-to-maturity financial assets | | (170,235,221) | (25,696,389) |
| Loans granted to related parties | | (118,250,000) | (30,304,487) |
| Loan repayments received from related parties | | 37,011,854 | 17,000,000 |
| Investments in associates | | – | (1,810,335) |
| Disposal of subsidiaries, net of cash disposed | | 3,653,483 | (2,978,059) |
| Interest received | | 6,724,660 | 4,103,536 |
| Net cash used in investing activities | | (298,389,467) | (99,496,430) |
| Cash flows from financing activities | | | |
| Proceeds from the issue of shares | | 151,880,637 | 31,078 |
| Transaction costs related to the issue of shares | | (7,300,142) | – |
| Purchase of treasury shares | | (3,818,100) | – |
| Proceeds from the issue of bonds | | 94,792,000 | – |
| Transaction costs related to the issue of bonds | | (721,328) | – |
| Proceeds from borrowings | | 7,681,060 | 71,002,146 |
| Repayment of borrowings | | (1,695,391) | (30,407,622) |
| Dividends paid | | (17,631,460) | (3,408,598) |
| Other distributions to owners | | – | (2,115,615) |
| Interest paid | | (3,927,652) | (5,019,287) |
| Net cash from financing activities | | 219,259,624 | 30,082,102 |
| Net change in cash and cash equivalents | | 43,080,618 | 5,639,395 |
| Cash and cash equivalents at beginning of the year | 9 | 20,187,588 | 14,127,579 |
| Exchange (losses) gains on cash and cash equivalents | | (808,791) | 420,614 |
| Cash and cash equivalents at end of the year | 9 | 62,459,415 | 20,187,588 |

The notes on pages 56 to 77 are an integral part of these consolidated financial statements

# Consolidated Statement of Changes in Equity

Tenge thousands unless otherwise stated

| | Attributable to equity holders of the Company | | | | |
|---|---|---|---|---|---|
| | Share capital | Other equity | Retained earnings | Minority interest | Total Equity |
| As at January 1, 2005 | 11,761,130 | 1,315,825 | 154,162,438 | 1,494,303 | 168,733,696 |
| Issue of shares (Note 11) | 31,078 | – | – | – | 31,078 |
| Changes in ownership in subsidiaries | – | (1,315,825) | (31,253,594) | (1,617,077) | (34,186,496) |
| Profit for the year | – | – | 45,074,642 | 202,310 | 45,276,952 |
| Dividends (Note 11) | – | – | (3,499,715) | – | (3,499,715) |
| Other distributions to owners | – | – | (2,622,952) | – | (2,622,952) |
| As at December 31, 2005 | 11,792,208 | – | 161,860,819 | 79,536 | 173,732,563 |
| Issue of shares (Note 11) | 251,302,373 | – | – | – | 251,302,373 |
| Treasury stock (Note 11) | (3,818,100) | – | – | – | (3,818,100) |
| Stock options (Note 11) | – | 92,249 | – | – | 92,249 |
| Changes in ownership in subsidiaries | – | – | – | (73,719) | (73,719) |
| Profit for the year | – | – | 122,561,334 | (117) | 122,561,217 |
| Dividends (Note 11) | – | – | (18,025,525) | – | (18,025,525) |
| Other distributions to owners (Note 19) | – | – | (13,243) | – | (13,243) |
| As at December 31, 2006 | 259,276,481 | 92,249 | 266,383,385 | 5,700 | 525,757,815 |

The notes on pages 56 to 77 are an integral part of these consolidated financial statements

# Notes to the Consolidated Financial Statements

Tenge thousands unless otherwise stated

## 1 Organization and principal activities

Joint Stock Company Exploration and Production KazMunaiGas (the "Company") is engaged in the acquisition, exploration, development, production, processing and export of hydrocarbons with its core operations of oil and gas properties located in the Pre-Caspian and Mangistau basins of western Kazakhstan. The Company's direct majority shareholder is Joint Stock Company National Company KazMunaiGas ("NC KMG" or the "Parent Company"), which represents the state's interests in the Kazakh oil and gas industry and which holds 56.77% of the Company's outstanding shares as at December 31, 2006. From June 2006 NC KMG was 100%-owned by Samruk State Holding which is in turn 100% owned by the government of the Republic of Kazakhstan (the "Government").

The Company conducts its principal operations through the UzenMunaiGas and EmbaMunaiGas production divisions. These consolidated financial statements reflect the financial position and results of operations of those divisions and certain other controlling and non-controlling interests in predominantly non-core entities. Such other interests represented approximately 3% of the Company's net assets at December 31, 2006 (2005: 7%). The Company plans to dispose of the remaining non-core businesses by the end of 2008.

These consolidated financial statements were authorized for issue by the Company's Chief Executive Officer, Chief Financial Officer and Group Financial Controller on March 12, 2007.

## 2 Summary of significant accounting policies

The principal accounting policies applied in the preparation of these consolidated financial statements are set out below. These policies have been consistently applied to all the years presented, unless otherwise stated.

### 2.1 Basis of preparation

These consolidated financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS"). The consolidated financial statements have been prepared under the historical cost convention except for financial instruments.

The preparation of financial statements in conformity with IFRS requires the use of certain critical accounting estimates. It also requires management to exercise its judgment in the process of applying the Company's accounting policies. The areas involving a higher degree of judgment or complexity, or areas where assumptions and estimates are significant to the consolidated financial statements are disclosed in Note 5.

*New accounting developments*
The following new standards, amendments to standards and interpretations are mandatory for the financial year ended December 31, 2006:

IAS 19 (Amendment), *Actuarial Gains and Losses, Group Plans and Disclosures*, effective for annual periods beginning on or after January 1, 2006, introduces an additional recognition option for actuarial gains and losses in post-employment defined benefit plans. The amendments to IAS 19 did not have a material impact on the Company's financial position or results of operations.

AS 21 (Amendment), *Net Investment in a Foreign Operation*, effective for annual periods beginning on or after January 1, 2006. The amendments to IAS 21 did not have a material impact on the Company's financial position or results of operations.

IAS 39 (Amendment), *The Fair Value Option*; IAS 39 (Amendment), *Cash Flow Hedge Accounting of Forecast Intragroup Transactions*; IAS 39 and IFRS 4 (Amendment), *Financial Guarantee Contracts*, all effective for annual periods beginning on or after January 1, 2006, clarified the use of fair values, clarified that the definition of a financial hedge extends to certain intercompany transactions and clarified the accounting for insurance contracts.

The amendments to IAS 39 and IFRS 4 did not have a material impact on the Company's financial position or results of operations.

IFRS 6, *Exploration for and Evaluation of Mineral Resources*, is effective for annual periods beginning on or after January 1, 2006. IFRS 6 permits the continued use of recognition and measurement practices for exploration and evaluation assets applied immediately before adopting the IFRS. IFRS 6 also provides specific guidance on impairment of exploration and evaluation assets. The adoption of IFRS 6 did not have a material impact on the Company's financial position or results of operations.

IFRIC 4, *Determining Whether an Arrangement Contains a Lease*, is effective for annual periods beginning on or after January 1, 2006. The adoption of IFRIC 4 did not have a material impact on the Company's financial position or results of operations.

IFRIC 5, *Rights to Interests Arising from Decommissioning, Restoration and Environmental Rehabilitation Funds*, is effective for annual periods beginning on or after January 1, 2006. The adoption of IFRIC 5 did not have a material impact on the Company's financial position or results of operations.

IFRIC 6, *Liabilities Arising from Participating in a Specific Market – Waste Electrical and Electronic Equipment*, is effective for annual periods beginning on or after December 1, 2005. The adoption of IFRIC 6 did not have a material impact on the Company's financial position or results of operations.

*IFRSs and IFRIC Interpretations not yet effective*
The Company has not applied the following IFRSs and IFRIC Interpretations that have been issued but are not yet effective:

- IFRS 7 "Financial Instruments: Disclosures";
- IAS 1 (amended 2005) "Presentation of Financial Statements – Capital Disclosures";
- IFRIC 8 "Scope of IFRS 2";
- IFRIC 9 "Reassessment of Embedded Derivatives";
- IFRIC 10 "Interim Financial Reporting and Impairment";
- IFRIC 11 "IFRS 2 - Group and Treasury Share Transactions"
- IFRIC 12 "Service Concession Arrangements"

The Company expects that the adoption of the pronouncements listed above will have no significant impact on the Company's results of operations and financial position in the period of initial application.

## 2.2 Consolidation

*Subsidiaries*
Subsidiaries are all entities over which the Company has the power to govern the financial and operating policies generally accompanying a shareholding of more than one half of the voting rights. The existence and effect of potential voting rights that are currently exercisable or convertible are considered when assessing whether the Company controls another entity. Subsidiaries are fully consolidated from the date on which control is transferred to the Company. They are de-consolidated from the date that control ceases.

Inter-company transactions, balances and unrealised gains on transactions between companies are eliminated. Unrealised losses are also eliminated but considered an impairment indicator of the asset transferred. Accounting policies of subsidiaries have been changed where necessary to ensure consistency with the policies adopted by the Company.

*Associates*
Associates are all entities over which the Company has significant influence but not control, generally accompanying a shareholding of between 20% and 50% of the voting rights. Investments in associates are accounted for using the equity method of accounting and are initially recognised at cost. The Company's investment in associates includes goodwill identified on acquisition, net of any accumulated impairment loss.

The Company's share of its associates' post-acquisition profits or losses is recognised in the income statement, and its share of post-acquisition movements in reserves is recognised in reserves. The cumulative post-acquisition movements are adjusted against the carrying amount of the investment. When the Company's share of losses in an associate equals or exceeds its interest in the associate, including any other unsecured receivables, the Company does not recognise further losses, unless it has incurred obligations or made payments on behalf of the associate.

Unrealised gains on transactions between the Company and its associates are eliminated to the extent of the Company's interest in the associates. Unrealised losses are also eliminated unless the transaction provides evidence of an impairment of the asset transferred. Accounting policies of associates have been changed where necessary to ensure consistency with the policies adopted by the Company.

Dilution gains and losses in associates are recognised in the income statement.

## 2.3 Foreign currency translation

*Functional and presentation currency*
Items included in the financial statements of each of the Company's entities are measured using the currency of the primary economic environment in which the entity operates ("the functional currency"). The consolidated financial statements are presented in Kazakhstan Tenge ("Tenge"), which is also the Company's functional currency.

*Transactions and balances*
Foreign currency transactions are translated into the functional currency using the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at year-end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognised in the income statement.

*Subsidiaries*
The results and financial position of all of the Company's subsidiaries (none of which has the currency of a hyperinflationary economy) that have a func-

tional currency different from the presentation currency are translated into the presentation currency as follows:

- assets and liabilities for each balance sheet pre sented are translated at the closing rate at the date of thwat balance sheet;
- income and expenses for each income statement are translated at average exchange rates (unless this average is not a reasonableap proximation of the cumulative effect of the rates prevailing on the trans action dates, in which case income and ex
- penses are translated at the rate on the dates of the transactions);
- all resulting exchange differences are recognised as a separate component of equity.

## 2.4 Oil and natural gas exploration and development expenditure

*License and property acquisition costs*
License and property acquisition costs are capitalized within intangible assets and amortized on a straight-line basis over the estimated period of exploration. Each property is reviewed on an annual basis to confirm that drilling activity is planned and it is not impaired. If no future activity is planned, the remaining balance of the license and property acquisition costs is written off. Upon determination of economically recoverable reserves ('proved reserves' or 'commercial reserves'), amortization ceases and the remaining costs are aggregated with exploration expenditure and held on a field-by-field basis as proved properties awaiting approval within other intangible assets. When development is approved internally, the relevant expenditure is transferred to property, plant and equipment.

*Exploration expenditure*
Geological and geophysical exploration costs are charged against income as incurred. Costs directly associated with an exploration well are capitalized within property, plant and equipment (construction work-in-progress) until the drilling of the well is complete and the results have been evaluated. These costs include employee remuneration, materials and fuel used, rig costs and payments made to contractors. If hydrocarbons are not found, the exploration expenditure is written off as a dry hole. If hydrocarbons are found and, subject to further appraisal activity, which may include the drilling of further wells (exploration or exploratory-type stratigraphic test wells), are likely to be capable of commercial development, the costs continue to be carried as an asset. All such carried costs are subject to technical, commercial and management review at least once a year to confirm the continued intent to develop or otherwise extract value from the discovery. When this is no longer the case, the costs are written off.

When proved reserves of oil and natural gas are determined and development is sanctioned, the relevant expenditure is transferred to oil and gas properties.

*Development expenditure*
Expenditure on the construction, installation or completion of infrastructure facilities such as platforms, pipelines and the drilling of development wells, except for expenditure related to development or delineation wells which do not find commercial quantities of hydrocarbons and are written off as dry hole expenditures in the period, is capitalized within property, plant and equipment.

## 2.5 Property, plant and equipment

Property, plant and equipment are stated at cost less accumulated depreciation, depletion and impairment.

The initial cost of an asset comprises its purchase price or construction cost, any costs directly attributable to bringing the asset into operation and the initial estimate of any decommissioning obligation, if any. The purchase price or construction cost is the aggregate amount paid and the fair value of any other consideration given to acquire the asset.

Oil and natural gas properties are depreciated using a unit-of-production method. Certain oil and gas property with useful lives less than the remaining life of the fields are depreciated on a straight-line basis over useful lives of 4-10 years. The cost of producing wells is amortized over proved developed reserves. License and property acquisition, decommissioning and field development costs are amortized over total proved reserves.

Other property, plant and equipment principally comprise buildings and machinery and equipment which are depreciated on a straight-line basis over average useful lives of 24 years and 7 years respectively.

The expected useful lives of property, plant and equipment are reviewed on an annual basis and, if necessary, changes in useful lives are accounted for prospectively.

The carrying value of property, plant and equipment is reviewed for impairment whenever events or changes in circumstances indicate the carrying value may not be recoverable.

An item of property, plant and equipment, inclusive of production wells which stop producing commercial quantities of hydrocarbons and are scheduled for abandonment, is derecognized upon disposal or when no future economic benefits are expected to arise from the continued use of the asset. Any gain or loss arising on derecognition of the asset (calculated as the difference between the net disposal proceeds and the carrying amount of the item) is included in the income statement in the period the item is derecognized.

## 2.6 Impairment of assets

The Company assesses assets or groups of assets for impairment whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. Individual assets are grouped for impairment assessment purposes at the lowest level at which there are identifiable cash flows that are largely independent of the cash flows of other groups of assets. If any such indication of impairment exists or when annual impairment testing for an asset group is required, the Company makes an estimate of its recoverable amount. An asset group's recoverable amount is the higher of its fair value less costs to sell and its value in use. Where the carrying amount of an asset group exceeds its recoverable amount, the asset group is considered impaired and is written down to its recoverable amount. In assessing value in use, the estimated future cash flows are adjusted for the risks specific to the asset group and are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money.

An assessment is made at each reporting date as to whether there is any indication that previously recognized impairment losses may no longer exist or may have decreased. If such indication exists, the recoverable amount is estimated. A previously recognized impairment loss is reversed only if there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognized. If that is the case, the carrying amount of the asset is increased to its recoverable amount. That increased amount cannot exceed the carrying amount that would have been determined, net of depreciation, had no impairment loss been recognized for the asset in prior years. Such reversal is recognized in profit or loss.

After such a reversal, the depreciation charge is adjusted in future periods to allocate the asset's revised carrying amount, less any residual value, on a systematic basis over its remaining useful life.

## 2.7 Intangible assets

Intangible assets are stated at cost, less accumulated amortization and accumulated impairment losses. Intangible assets include expenditure on acquiring licenses for oil and natural gas exploration and computer software. Intangible assets acquired separately from a business are carried initially at cost. The initial cost is the aggregate amount paid and the fair value of any other consideration given to acquire the asset.

The expected useful lives of the assets are reviewed on an annual basis and, if necessary, changes in useful lives are accounted for prospectively. Computer software costs have an estimated useful life of 3 to 7 years.

The carrying value of intangible assets is reviewed for impairment whenever events or changes in circumstances indicate the carrying value may not be recoverable.

## 2.8 Financial assets

Financial assets within the scope of IAS 39 are classified as either financial assets at fair value through profit or loss, loans and receivables, held to maturity investments, or available for sale financial assets, as appropriate. When financial assets are recognised initially, they are measured at fair value, plus, in the case of investments not at fair value through profit or loss, directly attributable transaction costs. The Company determines the classification of its financial assets at initial recognition. All regular way purchases and sales of financial assets are recognized on the trade date, which is the date that the Company commits to purchase the asset. Regular way purchases or sales are purchases or sales of financial assets that require delivery of assets within the period generally established by regulation or convention in the marketplace.

Non-derivative financial assets with fixed or determinable payments and fixed maturity are classified as held-to-maturity when the Company has the positive intention and ability to hold them to maturity. The Company classifies its cash deposits and bonds as held-to-maturity investments because management has the positive intention and ability to hold these instruments to maturity.

The Company assesses at each balance sheet date whether there is objective evidence that a financial asset or a group of financial assets is impaired.

## 2.9 Inventories

Inventories are stated at the lower of cost and net realizable value on a first-in first-out ("FIFO") basis. Cost includes all costs incurred in the normal course of business in bringing each product to its present location and condition. The cost of crude oil and refined products is the cost of production, including the appropriate proportion of DD&A and overheads based on normal capacity. Net realizable value of crude oil and refined products is based on estimated selling price in the ordinary course of business less any costs expected to be incurred to completion and disposal. Materials and supplies inventories are carried at amounts that do not exceed the expected amounts recoverable in the normal course of business.

## 2.10 Trade and other receivables

Trade receivables, which generally have a short term, are carried at original invoice amount less an allowance for any uncollectible amounts. Allowance is made when there is objective evidence that the Company will not be able to collect the debts.

## 2.11 Value added tax (VAT)

The tax authorities permit the settlement of VAT on sales and purchases on a net basis. VAT recoverable represents VAT on domestic purchases net of VAT on domestic sales. Export sales are zero rated.

## 2.12 Cash and cash equivalents

Cash and cash equivalents include cash on hand, demand deposits with banks, other short-term highly liquid investments with original maturities of three months or less.

## 2.13 Share capital

*Share Capital*
Ordinary shares and non-redeemable preference shares with discretionary dividends are both classified as equity. External costs directly attributable to the issue of new shares, other than on a business combination, are shown as a deduction from the proceeds in equity. Any excess of the fair value of consideration received over the par value of shares issued is recognised as an additional paid-in capital.

*Treasury Shares*
Where the Company or its subsidiaries purchases the Company's shares, the consideration paid, including any attributable transaction costs, net of income taxes, is deducted from equity as treasury shares until they are cancelled or reissued. No gain or loss is recognized in the income statement on the purchase, sale, issue or cancellation of the Company's own equity instruments. Where such shares are subsequently sold or reissued, any consideration received is included in equity. Treasury shares are stated at weighted average cost.

*Minority Interest*

Minority interest represents the interest in subsidiaries not held by the Company. Minority interest at the balance sheet date represents the minority shareholders' portion of the fair value of the identifiable assets and liabilities of the subsidiaries at the acquisition date and the minorities' portion of movements in equity since the date of the Company's formation. Minority interest is presented within the shareholders' equity. Losses allocated to minority interest do not exceed the minority interest in the equity of the subsidiaries unless there is a binding obligation of the minority to fund the losses. All such losses are allocated to the Company.

*Dividends*

Dividends are recognised as a liability and deducted from equity at the balance sheet date only if they are declared before or on the balance sheet date. Dividends are disclosed when they are proposed before the balance sheet date or proposed or declared after the balance sheet date but before the financial statements are authorised for issue.

## 2.14 Trade payables

Trade payables are recognised initially at fair value and subsequently measured at amortised cost using the effective interest method.

## 2.15 Borrowings

Borrowings are recognised initially at fair value, net of transaction costs incurred. Borrowings are subsequently measured at amortised cost; any difference between the proceeds (net of transaction costs) and the redemption value is recognised in the income statement over the period of the borrowings using the effective interest method. Borrowings are classified as current liabilities unless the Company has an unconditional right to defer settlement of the liability for at least 12 months after the balance sheet date. Borrowing costs are recognised as an expense when incurred.

## 2.16 Deferred income tax

Deferred tax assets and liabilities are calculated in respect of temporary differences using the balance sheet method. Deferred income taxes are provided for all temporary differences arising between the tax bases of assets and liabilities and their carrying values for financial reporting purposes, except where the deferred income tax arises from the initial recognition of goodwill or of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit nor taxable profit or loss.

A deferred tax asset is recorded only to the extent that it is probable that taxable profit will be available against which the deductible temporary differences can be utilised. Deferred tax assets and liabilities are measured at tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates that have been enacted or substantively enacted at the balance sheet date.

Deferred income tax is provided on temporary differences arising on investments in subsidiaries and associates, except where the timing of the reversal of the temporary difference can be controlled and it is probable that the temporary difference will not reverse in the foreseeable future.

## 2.17 Employee benefits

*Pension scheme*

The Company withholds 10% from the salary of its employees as the employees' contribution to their designated pension funds. The pension deductions are limited to 75 minimal monthly salary levels of 9,200 Tenge per month in 2006 (2005: 7,000 Tenge). Under the current Kazakhstan legislation, employees are responsible for their retirement benefits

## 2.18 Revenue recognition

The Company sells crude oil under short-term agreements priced by reference to Platt's index quotations and adjusted for freight, insurance and quality differentials. Title typically passes and revenues are recognized when crude oil is physically placed onboard a vessel or offloaded from the vessel, transferred into pipe or other delivery mechanism depending on the contractually agreed terms.

The Company's crude oil sale contracts generally specify maximum quantities of crude oil to be delivered over a certain period. Crude oil shipped but not yet delivered to the customer is recorded as inventory in the balance sheet. Revenues on sales of oil products are recognized when transfer of ownership occurs and title is passed, either at the point of delivery or the point of receipt, depending on contractual conditions.

## 2.19 Income taxes

Excess profit tax (EPT) is treated as an income tax and forms part of income tax expense. In accordance with the subsoil agreements, the Company accrues and pays EPT, at a rate in the range of 30 to 50% of after tax profit which has been adjusted for specific deductions in accordance with the applicable subsoil agreements, when certain internal rates of return are exceeded.

The internal rate of return is calculated based on the cash flows from each subsoil agreement, adjusted for the national inflation rate. Deferred tax is calculated with respect to both corporate income tax (CIT) and EPT. Deferred EPT is calculated on temporary differences for assets allocated to contracts for subsoil use at the expected rate of EPT to be paid under the contract.

## 2.20 Comparative amounts

Certain prior period amounts have been reclas sified to conform to current period presentation.

# 3 Significant non-cash transactions

During 2006 the Company settled in crude oil 17,503,720 thousand Tenge due under the terms of a pre-export financing agreement (2005: 13,676,456 thousand Tenge).

At the date of IPO (Note 11.1) the Company exchanged 9,247,946 ordinary shares for US$800 million senior notes plus accumulated interest. The Company's notes had been placed on July 10, 2006 (Note 9).

These non-cash transactions are excluded from the consolidated statement of cash flows.

# 4 Financial risk factors

*Commodity price risk*
The Company is exposed to commodity price risk, since oil prices are determined by the world market. The Company does not hedge this risk.

*Interest rate risk*
The Company's interest rate risk relates to interest receivable and payable on its cash deposits and borrowings. The Company hedges its exposure on its variable rate debt instruments.

*Foreign exchange risk*
Most of the Company's cash inflows as well as accounts receivable balances are denominated in US dollars, while most of the Company's purchases are denominated in Tenge. The Company does not use foreign exchange or forward contracts to manage its exposure to changes in foreign exchange rates.

*Credit risk*
Financial instruments that could subject the Company to credit risk principally comprise related party loans, accounts receivable and cash deposits. Most notably, at December 31, 2006 the Company had 69% (2005: 57%) of total trade and other receivable from one customer, a related party (Note 19). While the Company may be subject to losses up to the contract value of the instruments in the event of non-performance by its counterparts, it does not expect such losses to occur.

*Fair values*
The fair value of financial instruments, consisting of cash, loans and receivables, and payables and obligations under debt instruments, approximate their carrying values. For trade receivables fair value is the nominal value less provision for uncollectible amounts. The fair value of financial liabilities and other financial assets for disclosure purposes is estimated by discounting the future contractual cash flows at the current market interest rate that is available to the Company for similar financial instruments.

# 5 Significant accounting estimates and judgments

The preparation of consolidated financial statements in conformity with IFRS requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of assets, liabilities, revenues and expenses, and the disclosure of contingent assets and liabilities during the reporting period. The most significant estimates are discussed below:

*Oil and gas reserves*
Oil and gas reserves are a material factor in the Company's computation of DD&A. The Company estimates its reserves of oil and gas in accordance with the methodology of the Society of Petroleum Engineers (SPE). In estimating its reserves under SPE methodology, the Company uses long-term planning prices which are also used by management to make investment decisions about development of a field. Using planning prices for estimating proved reserves removes the impact of the volatility inherent in using year end spot prices. Management believes that long-term planning price assumptions are more consistent with the long-term nature of the upstream business and provide the most appropriate basis for estimating oil and gas reserves. All reserve estimates involve some degree of uncertainty. The uncertainty depends chiefly on the amount of reliable geological and engineering data available at the time of the estimate and the interpretation of this data.

The relative degree of uncertainty can be conveyed by placing reserves into one of two principal classifications, either proved or unproved. Proved reserves are more certain to be recovered than unproved reserves and may be further sub-classified as developed and undeveloped to denote progressively increasing uncertainty in their recoverability. The Company's proved reserves almost exclusively comprise proved developed reserves. Estimates are reviewed and revised annually. Revisions occur due to the evaluation or re-evaluation of already available geological, reservoir or production data; availability of new data; or changes to underlying price assumptions. Reserve estimates may also be revised due to improved recovery projects, changes in production capacity or changes in development strategy. Proved reserves are used to calculate the unit of production rates for DD&A. The Company has included in proved reserves only those quantities that are expected to be produced during the initial license period. This is due to the uncertainties surrounding the outcome of such renewal procedures, since the renewal is ultimately at the discretion of the Government. An increase in the Company's license periods and corresponding increase in reported reserves would generally lead to lower DD&A expense and could materially affect earnings. A reduction in proved developed reserves will increase DD&A expense (assuming constant production), reduce income and could also result in an immediate write-down of the property's book value. Given the relatively small number of producing fields, it is possible that any changes in reserve estimates year on year could significantly affect prospective charges for DD&A.

*Asset retirement obligations*

Under the terms of certain contracts, legislation and regulations the Company has legal obligations to dismantle and remove tangible assets and restore the land at each production site. Specifically, the Company's obligation relates to the ongoing closure of all non-productive wells and final closure activities such as removal of pipes, buildings and recultivation of the contract territories. Since the license terms cannot be extended at the discretion of the Company, the settlement date of the final closure obligations has been assumed to be the end of each license period. If the asset retirement obligations were to be settled at the end of the economic life of the properties, the recorded obligation would increase significantly due to the inclusion of all abandonment and closure costs. The extent of the Company's obligations to finance the abandonment of wells and for final closure costs depends on the terms of the respective contracts and current legislation. Where neither contracts nor legislation include an unambiguous obligation to undertake or finance such final abandonment and closure costs at the end of the license term, no liability has been recognized. There is some uncertainty and significant judgment involved in making such a determination. Management's assessment of the presence or absence of such obligations could change with shifts in policies and practices of the Government or in the local industry practice. If the Company's asset retirement obligation included the costs of abandoning all productive wells at the end of the license period and recultivating the related sites, the total asset retirement obligation would increase by approximately 9.5 billion Tenge. The Company calculates asset retirement obligations separately for each contract. The amount of the obligation is the present value of the estimated expenditures expected to be required to settle the obligation adjusted for expected inflation and discounted using average long-term risk-free interest rates for emerging market sovereign debt adjusted for risks specific to the Kazakhstan market. The Company reviews site restoration provisions at each balance sheet date, and adjusts them to reflect the current best estimate in accordance with IFRIC 1 "Changes in Existing Decommissioning, Restoration and Similar Liabilities". Estimating the future closure costs involves significant estimates and judgments by management. Most of these obligations are many years in the future and, in addition to ambiguities in the legal requirements, the Company's estimate can be affected by changes in asset removal technologies, costs and industry practice. Approximately 9.4% of the provision at December 31, 2006 and 2005 relates to final closure costs. Uncertainties related to the final closure costs are mitigated by the effects of discounting the expected cash flows. The Company estimates future well abandonment cost using current year prices and the average long-term inflation rate.

The long-term inflation and discount rates used to determine the balance sheet obligation at December 31, 2006 were 5.0% and 7.9% respectively (2005: 5.0% and 7.9%). Movements in the provision for asset retirement obligations are disclosed in Note 14.

*Environmental remediation*

The Company also makes judgments and estimates in establishing provisions for environmental remediation obligations. Environmental expenditures are capitalized or expensed depending upon their future economic benefit. Expenditures that relate to an existing condition caused by past operations and do not have a future economic benefit are expensed.

Liabilities are determined based on current information about costs and expected plans for remediation and are recorded on an undiscounted basis if the timing of the procedures has not been agreed with the relevant authorities. The Company's environmental remediation provision represents management's best estimate based on an independent assessment of the anticipated expenditure necessary for the Company to remain in compliance with the current regulatory regime in Kazakhstan. Pursuant to a memorandum of understanding ("MOU") signed with the Ministry of the Environment in July 2005, the Company agreed to take responsibility for remediation of certain soil contamination and oil waste disposal which resulted from oil extraction dating back to the commencement of production. As at the date of these financial statements the scope and timing of the remediation plan has not been formally agreed with the Government. Accordingly, the liability has not been discounted. Because the original terms of the liability have not yet been established and management reasonably expects to execute the remediation plan over a period of up to ten years, the Company has classified this obligation as non-current except for the portion of costs expected to be incurred in 2007. For environmental remediation provisions, actual costs can differ from estimates because of changes in laws and regulations, public expectations, discovery and analysis of site conditions and changes in clean-up technology. Further uncertainties related to environmental remediation obligations are detailed in Note 20. Movements in the provision for environmental remediation obligations are disclosed in Note 14.

*Taxation*

In assessing tax risks, management considers to be probable obligations the known areas of tax positions which the Company would not appeal or does not believe it could successfully appeal, if assessed by tax authorities. Such determinations inherently involve significant judgment and are subject to change as a result of changes in tax laws and regulations, amendments to the taxation terms of the Company's subsoil agreements, the determination of expected outcomes from pending tax proceedings and current outcome of ongoing compliance audits by tax authorities. The provision for tax risks disclosed in Note 14 relates mainly to the Company's application of Kazakhstan transfer pricing legislation to export sales of crude oil during the years 2002 to 2006. Further uncertainties related to taxation are detailed in Note 20.

*Historical obligation*

Included in trade and other payables is an accrual of 8.0 billion Tenge (2005: 8.4 billion) related to obligations of the Company under one of the subsoil agreements to reimburse the Government for exploration costs incurred prior to the beginning of the current license agreements. The Company was to conclude a separate agreement with the Government with respect to such reimbursement within sixty days of the signing of the subsoil use contract in 1998. As at December 31, 2006 no such agreement had been concluded. For about half of the contract fields the amount of the accrual has been determined based on calculations prepared by regulatory authorities in 2003. The remaining part of the accrual was estimated by management based on historical exploratory well data. The accrual is classified as current at December 31, 2006 due to the Company not having the unconditional right to defer such obligation for at least 12 months. The obligation is denominated in US dollars and the carrying value is adjusted each period for foreign exchange movements.

# 6 Discontinued operations

On December 29, 2005 the Company disposed of Atyrau refinery within the NC KMG Group for 3.5 billion Tenge after acquiring the refinery in a par value share exchange with the Parent Company. In 2005 the Company increased its interest from 86.7% to 99.1% through cash contributions of approximately 25 billion Tenge. The disposal resulted in a decrease in shareholders equity of 34.2 billion Tenge. The effects of the disposal were recorded in equity because the counterparty to this transaction is controlled by the principal equity holder. The disposal also resulted in decreases in the following balance sheet items: non-current assets (primarily property, plant and equipment) 58.7 billion Tenge, current assets 17.7 billion Tenge, borrowings 32.5 billion Tenge and other liabilities of 6.1 billion Tenge.

| | 2005 |
|---|---|
| Revenue | 8,854,241 |
| Expenses | (5,350,959) |
| Profit before tax of discontinued operations | 3,503,282 |
| Tax | (1,982,152) |
| Profit after tax of discontinued operations | 1,521,130 |
| | |
| Operating cash flows | 160,194 |
| Investing cash flows | (13,401,139) |
| Financing cash flows | (809,995) |
| Total cash flows of discontinued operations | (14,050,940) |

Historically the Company has purchased tolling services from the refinery to meet its local market obligation. Tolling expenses amounted to around 5 billion Tenge in each of the years presented and have been eliminated in these financial statements with all other inter-company transactions. In late 2005 the Company began selling crude oil directly to the refinery. Those sales amounted to around 6.5 billion Tenge and were also eliminated in consolidation. Going forward at least through 2010 the Company expects to increase crude oil sales to the refinery to around 2.2 million metric tons ("tons") per year at terms of cost plus 3% and reduce to an insignificant amount the purchase of tolling services.

# 7 Property, plant and equipment

| | Oil-and-gas properties | Other assets | Construction work-in-progress | Total |
|---|---|---|---|---|
| 2005 | | | | |
| Opening net book amount at January 1, 2005 | 171,791,340 | 51,018,310 | 35,148,550 | 257,958,200 |
| Additions | 10,975,517 | 10,766,359 | 60,065,268 | 81,807,144 |
| Disposals related to discontinued operations | – | (10,935,164) | (50,852,587) | (61,787,751) |
| Other disposals | (3,003,271) | (6,218,463) | (999,857) | (10,221,591) |
| Transfers from work-in-progress | 26,314,228 | 7,160,857 | (33,475,085) | – |
| Depreciation charge | (18,332,498) | (6,224,762) | – | (24,557,260) |
| Impairment | – | (66,908) | – | (66,908) |
| Closing net book amount at December 31, 2005 | 187,745,316 | 45,500,229 | 9,886,289 | 243,131,834 |
| At December 31, 2005 | | | | |
| Cost | 235,613,254 | 54,966,841 | 9,886,289 | 300,466,384 |
| Accumulated depreciation | (47,867,938) | (9,466,612) | – | (57,334,550) |
| Net book amount | 187,745,316 | 45,500,229 | 9,886,289 | 243,131,834 |
| 2006 | | | | |
| Opening net book amount at January 1, 2006 | 187,745,316 | 45,500,229 | 9,886,289 | 243,131,834 |
| Additions | 16,642,063 | 8,352,989 | 29,711,178 | 54,706,230 |
| Disposals | (2,829,741) | (6,047,369) | (3,803,098) | (12,680,208) |
| Transfers from work-in-progress | 22,551,461 | 2,846,849 | (25,398,310) | – |
| Depreciation charge | (21,438,939) | (4,385,545) | – | (25,824,484) |
| Closing net book amount At December 31, 2006 | 202,670,160 | 46,267,153 | 10,396,059 | 259,333,372 |
| At December 31, 2006 | | | | |
| Cost | 270,185,271 | 56,644,462 | 10,396,059 | 337,225,792 |
| Accumulated depreciation | (67,515,111) | (10,377,309) | – | (77,892,420) |
| Net book amount | 202,670,160 | 46,267,153 | 10,396,059 | 259,333,372 |

As at December 31, 2006, construction work-in-progress includes a net book value of exploration and evaluation assets in the amount of 166,298 thousand Tenge (2005: 343,928 thousand Tenge). Additions of these assets during 2006 amounted to 1,312,855 thousand Tenge (2005: 1,201,023 thousand Tenge) and disposals amounted to 1,490,485 thousand Tenge (2005: 1,304,754 thousand Tenge), including write off of dry exploratory wells during the period amounting to 526,596 thousand Tenge (2005: 1,304,754 thousand Tenge).

# 8 Intangible assets

| | 2006 | 2005 |
|---|---|---|
| At January 1 | | |
| Opening net book amount | 1,340,657 | 972,875 |
| Additions | 9,413,856 | 747,954 |
| Disposals | (4,757) | (53,832) |
| Amortization charge | (2,828,504) | (326,340) |
| Closing net book amount | 7,921,252 | 1,340,657 |
| | | |
| At December 31 | | |
| Cost | 10,908,011 | 1,622,555 |
| Accumulated amortization | (2,986,759) | (281,898) |
| Net book amount | 7,921,252 | 1,340,657 |

Included in additions for 2006 are the contract and license rights for exploration and production activities in Western Kazakhstan that the Company purchased from Aral Petroleum LLP in January 2006 for total cash consideration of 8.6 billion Tenge. The acquired exploration rights expire in February 2009.

# 9 Financial assets

*Other financial assets*

| | 2006 | 2005 |
|---|---|---|
| Loan receivable from NC KMG (Note 19) | 100,786,068 | – |
| US dollar-denominated deposits | – | 47,488,350 |
| Other | 2,055,333 | 6,474,788 |
| Total non-current | 102,841,401 | 53,963,138 |
| | | |
| Tenge-denominated deposits | 131,995,651 | – |
| US dollar-denominated deposits | 90,461,651 | 6,688,500 |
| Loans receivable (Note 19) | – | 12,639,487 |
| Other | 4,065,722 | 665,270 |
| Total current | 226,523,024 | 19,993,257 |
| | 329,364,425 | 73,956,395 |

The weighted average interest rate on US dollar-denominated deposits in 2006 was 7.6% (2005: 6.6%). The weighted average interest rate on Tenge-denominated deposits in 2006 was 8.1%. Other current financial assets as of December 31, 2006 consist primarily of US dollar-denominated bonds with weighted average interest rates of 4%.

On June 30, 2006 the Company entered into an agreement with NC KMG to acquire NC KMG's interests in JV KazGerMunai, representing 50% of the participatory interest in JV KazGerMunai (see Note 22). Under the terms of the agreement, in consideration of the Company providing financial support to NC KMG to finance the acquisition, the Company received a right to purchase the acquired interest at fair market value, which is to be negotiated and determined between the Company and NC KMG. Pursuant to the above on July 10, 2006, the Company's finance subsidiary, Munaishy Finance B.V., issued US$800 million of 6.5% fixed rate senior notes due in 2009 and loaned the proceeds from the issue to NC KMG (Note 3). The repayment of the loan is scheduled for 2009 (same date as the Munaishy Finance B.V. issuance) and accrues interest at 6.6% fixed per annum.

No amount has been recognised in these financial statements to account for the option to acquire KazGerMunai due to the negligible value of the option and ultimate exercise of the option being outside of the control of the Company.

*Trade and other receivables*

| | 2006 | 2005 |
|---|---|---|
| Trade receivables | 37,273,438 | 38,752,145 |
| Other | 3,378,453 | 8,061,865 |
| Allowance for doubtful receivables | (3,295,290) | (895,784) |
| | 37,356,601 | 45,918,226 |

As of December 31, 2006 US dollar-denominated trade and other receivables represented 89% of total receivables (2005: 80%). The remaining balances are Tenge-denominated.

In 2004 the Company purchased a 50% interest in Atoll JSC for approximately 5 billion Tenge. In 2005 the Company sold a 35% interest in Atoll to the other shareholder for 3.2 billion Tenge.

In 2006 the Company has fully provided for the 3.2 billion Tenge receivable from the above sale. Additionally, an impairment loss has been recognised as at December 31, 2006 to write the remaining investment in Atoll down to zero, which is management's best estimate of the current fair value of the investment.

*Cash and cash equivalents*

| | 2006 | 2005 |
|---|---|---|
| Term deposits | 58,399,928 | 9,815,804 |
| Cash in bank and in hand | 4,059,487 | 10,371,784 |
| | 62,459,415 | 20,187,588 |

The weighted average interest rate on US dollar-denominated deposits in 2006 was 5.6% (2005: 5%). The weighted average interest rate on Tenge-denominated deposits in 2006 was 5.6% (2005: 3.2%). Approximately 23% of total cash and cash equivalents at year end 2006 are US dollar-denominated (about 70% for 2005). The remaining balances are Tenge-denominated.

# 10 Inventories

| | 2006 | 2005 |
|---|---|---|
| Materials | 10,053,765 | 11,060,833 |
| Crude oil | 5,077,854 | 4,348,825 |
| | 15,131,619 | 15,409,658 |

# 11 Share capital

| | Shares outstanding (number of hares) | | | | |
|---|---|---|---|---|---|
| | Common shares | Preferred shares | Common shares | Preffered shares | Total share capital |
| As at January 1, 2005 | 42,926,820 | 4,117,699 | 10,731,705 | 1,029,425 | 11,761,130 |
| Issue of shares | 124,312 | – | 31,078 | – | 31,078 |
| As at December 31, 2005 | 43,051,132 | 4,117,699 | 10,762,783 | 1,029,425 | 11,792,208 |
| Issue of shares | 27,169,803 | 18,408 | 251,297,771 | 4,602 | 251,302,373 |
| Treasury stock | (341,530) | – | (3,818,100) | – | (3,818,100) |
| As at December 31, 2006 | 69,879,405 | 4,136,107 | 258,242,454 | 1,034,027 | 259,276,481 |

## 11.1 Share capital

*Authorized shares*

The total number of authorized ordinary and preferred shares is 70,220,935 (2005: 70,220,935) and 4,136,107 (2005: 4,136,107), respectively.

*Initial public offering (IPO)*

On September 28, 2006, the Company placed Ordinary Shares at 11,163.39 Tenge per share and Global Depository Receipts ("GDR") at US $14.64 (equivalent to 1,860.57 Tenge) per GDR (each GDR represents 1/6 of an ordinary share), on the Kazakhstan Stock Exchange and London Stock Exchange, respectively. The global offer consisted of 23,086,791 newly issued ordinary shares and 3,463,019 ordinary shares, which were offered by NC KMG. Ordinary Share and GDR trading has commenced on the Exchanges on October 4, 2006. At the time of the IPO 539,125 ordinary shares were issued to minority shareholders at 250 tenge per share. Each Ordinary share has the same voting rights as 6 GDRs.

*Preferred stock*

Preferred stockholders are entitled to participate equally in dividends with the holders of common stock and in any case are entitled, at the discretion of the Company's Board of Directors, to an annual cumulative dividend of 25 Tenge per share. Preferred shareholders receive the right to vote if the general meeting of shareholders considers decisions restricting rights of preferred shareholders, decisions on reorganization or liquidation of the Company and if dividends on preferred shares are not paid within three months after a specified payment date.

*Treasury stock*

On September 28, 2006 the Company purchased 2,049,180 GDRs at a weighted average price of US $14.64. The shares are held in trust by a special purpose entity and are expected to be used for employee share option plans. The Company consolidates the trust, as in substance, the activities of the trust are being conducted on behalf of the Company. Additionally, the ultimate benefits and risks of the trust reside with the Company.

*Dividends*

In accordance with Kazakhstan legislation, dividends may not be declared if the Company has negative equity in its Kazakh statutory financial statements or if the payment of dividends would result in negative equity in the statutory financial statements. Total dividends per share recognized as distributions to equity holders during the period amounted to 382 Tenge per share (2005: 74.20 Tenge per share) for both ordinary and preferred shares.

### 11.2 Employee share option plan

During 2006 the Company established a share option plan. A one-time award for its employees and directors was established to reward performance in relation to the IPO process. The IPO award date was December 29, 2006. An additional plan with an award date of October 4, 2006 was created to incentivise management. The following outlines the details of both plans and activity in the year:

| | IPO Plan | | Incentive Plan | |
|---|---|---|---|---|
| | Number of GDR's | Exercise price ($) | Number of GDR's | Exercise price ($) |
| Granted options | 342,553 | Nil | 575,059 | 14.64 |
| Outstanding as at December 31, 2006 | 342,553 | Nil | 575,059 | 14.64 |
| | Other Plan Details | | Other Plan Details | |
| Weighted average fair value of options granted during the year ($) | 19.17 | | 7.93 | |
| Vesting period | 1 year | | 1/3 each year over 3 years | |
| Average life remaining | 6 years | | 6 years | |

The Company recognized total expenses of 92,249 thousand Tenge related to equity-settled share-based payment transactions in 2006.

# 12 Earnings per share

| | 2006 | 2005 |
|---|---|---|
| Weighted avg. number of all shares outstanding | 54,119,532 | 47,150,748 |
| Continuing operations | | |
| Profit attributable to equity holders of the Company | 122,561,334 | 43,755,822 |
| Basic and diluted earnings per share | 2.26 | 0.93 |
| Discontinued operations | | |
| Profit attributable to equity holders of the Company | – | 1,318,820 |
| Basic and diluted earnings per share | – | 0.03 |

The above presentation includes both ordinary and preferred shares as preferred shareholders have cumulative participating rights which result in identical earnings per share for both classes of shares.

# 13 Borrowings

| | 2006 | 2005 |
|---|---|---|
| Fixed interest rate borrowings | 53,947,580 | 69,309,083 |
| Weighted average interest rates | 5.83% | 6.32% |
| Variable interest rate borrowings | 5,720,114 | 5,840,832 |
| Weighted average interest rates | 5.44% | 6.33% |
| Total borrowings | 59,667,694 | 75,149,915 |
| | | |
| Tenge-denominated borrowings | 664,257 | 859,377 |
| US dollar-denominated borrowings | 59,003,437 | 74,290,538 |
| Total borrowings | 59,667,694 | 75,149,915 |
| | | |
| Current portion | 21,695,307 | 21,121,175 |
| Maturity between 1 and 2 years | 19,816,717 | 19,082,221 |
| Maturity between 2 and 5 years | 17,393,391 | 34,451,834 |
| Maturity over 5 years | 762,279 | 494,685 |
| Total borrowings | 59,667,694 | 75,149,915 |
| | | |
| Undrawn facilities at fixed rate: | | |
| Expiring within one year | 2,514,098 | 3,986,709 |
| Expiring beyond one year | – | 13,709,100 |
| | 2,514,098 | 17,695,809 |

Most of the Company's borrowings (2006: 51,094,758 thousand Tenge, 2005: 66,598,200 thousand Tenge) relate to a pre-export financing arrangement which expires in 2009 and requires settlement in crude oil.

# 14 Provisions

| | Environmental remediation | Taxes | Asset retirement obligation | Other | Total |
|---|---|---|---|---|---|
| At January 1, 2005 | 33,028,060 | 18,644,946 | 16,305,869 | 1,659,876 | 69,638,751 |
| Additional provisions | – | 4,874,542 | 351,046 | 1,072,412 | 6,298,000 |
| Unused amounts reversed | – | – | (29,772) | – | (29,772) |
| Unwinding of discount | – | – | 1,293,055 | – | 1,293,055 |
| Changes in estimate | (663,230) | – | 995,322 | – | 332,092 |
| Used during the year | (1,331,100) | – | (869,172) | (189,989) | (2,390,261) |
| Current portion | 821,577 | 23,519,488 | 900,163 | 198,989 | 25,440,217 |
| Non-current portion | 30,212,153 | – | 17,146,185 | 2,343,310 | 49,701,648 |
| At December 31, 2005 | 31,033,730 | 23,519,488 | 18,046,348 | 2,542,299 | 75,141,865 |
| Additional provisions | – | 974,524 | 805,286 | 868,694 | 2,648,504 |
| Unused amounts reversed | – | (4,915,889) | (35,118) | – | (4,951,007) |
| Unwinding of discount | – | – | 1,431,075 | – | 1,431,075 |
| Changes in estimate | – | – | 2,186,862 | – | 2,186,862 |
| Used during the year | (1,014,767) | (1,792,643) | (677,185) | (186,005) | (3,670,600) |
| Current portion | 1,619,352 | 17,785,480 | 1,026,968 | 199,025 | 20,630,825 |
| Non-current portion | 28,399,611 | – | 20,730,300 | 3,025,963 | 52,155,874 |
| At December 31, 2006 | 30,018,963 | 17,785,480 | 21,757,268 | 3,224,988 | 72,786,699 |

Release of tax provision during 2006 primarily relates to the clarification in the Company's subsoil agreement for the Uzen field (Note18) and expiration of the statute of limitations with respect to provisions related to activities in 2001.

# 15 Revenue

| | 2006 | 2005 |
|---|---:|---:|
| Export: | | |
| Crude oil | 359,386,708 | 302,488,673 |
| Refined products | – | 651,491 |
| Domestic (Note 19): | | |
| Crude oil | 37,087,091 | 6,930,889 |
| Refined products | 7,618,461 | 32,812,045 |
| Gas products | 3,623,586 | 4,082,068 |
| Other sales and services | 4,491,941 | 1,922,654 |
| | 412,207,787 | 348,887,820 |

# 16 Operating expenses

| | 2006 | 2005 |
|---|---:|---:|
| Transportation | 44,060,096 | 40,106,224 |
| Employee benefits | 37,512,548 | 37,116,032 |
| Depreciation, depletion and amortization | 27,758,826 | 24,362,896 |
| Repairs and maintenance | 18,988,262 | 16,845,303 |
| Royalties | 15,850,891 | 15,180,580 |
| Materials and supplies | 11,661,063 | 21,658,853 |
| Other taxes | 9,666,804 | 7,103,491 |
| Social projects | 7,850,402 | 1,791,551 |
| Management fees and commissions (Note 19) | 7,678,179 | 11,976,634 |
| Energy | 6,563,701 | 5,824,741 |
| Fines and penalties | 363,994 | 4,056,539 |
| Environmental fine (Note 20) | (11,427,595) | 11,427,595 |
| Other | 18,002,909 | 9,583,488 |
| | 194,530,080 | 207,033,927 |

# 17 Finance (expense) income

| | 2005 | 2006 |
|---|---|---|
| Financial income | 13,525,630 | 6,221,012 |
| Financial expense | (9,581,373) | (5,115,993) |
| Foreign exchange (losses) gains | (4,060,138) | 276,041 |
| | (115,881) | 1,381,060 |

# 18 Income taxes

Income tax expense comprised the following for the years ended December 31:

| | 2006 | 2005 |
|---|---|---|
| Corporate income tax | 75,691,683 | 55,407,550 |
| Excess profit tax | 41,105,194 | 47,411,026 |
| Excess profit tax of prior years | (18,642,077) | – |
| Current income tax | 98,154,800 | 102,818,576 |
| Corporate income tax | (1,046,070) | (1,983,507) |
| Excess profit tax | (2,435,909) | (1,642,430) |
| Deferred income tax | (3,481,979) | (3,625,937) |
| Income tax expense | 94,672,821 | 99,192,639 |

The following table provides a reconciliation of the Kazakhstan income tax rate (30% in 2006 and 2005) to the effective tax rate of the Company on profit before tax.

| | 2006 | 2005 |
|---|---|---|
| Profit before tax | 217,234,038 | 142,948,461 |
| Income tax | 94,672,821 | 99,192,639 |
| Effective tax rate | 44% | 69% |
| | | % of profit before tax |
| Statutory income tax | 30 | 30 |
| Increase (decrease) resulting from | | |
| Excess profit tax | 20 | 32 |
| Excess profit tax of prior years | (9) | – |
| Movement in provisions | (2) | – |
| Tax effect of items which are not deductible or assessable for taxation purposes | 5 | 7 |
| Effective tax rate | 44 | 69 |

The movements in the deferred tax liability relating to CIT and EPT were as follows:

| | Fixed assets | Provisions | Other | Total |
|---|---|---|---|---|
| At January 1, 2005 | 29,500,770 | (2,707,958) | (8,306,998) | 18,485,814 |
| Income statement effect | (4,965,164) | 70,825 | 1,268,402 | (3,625,937) |
| Acquisitions and disposals | (662,197) | – | – | (662,197) |
| At December 31, 2005 | 23,873,409 | (2,637,133) | (7,038,596) | 14,197,680 |
| Income statement effect | (5,609,303) | 1,261,990 | 865,334 | (3,481,979) |
| At December 31, 2006 | 18,264,106 | (1,375,143) | (6,173,262) | 10,715,701 |

On December 29, 2006 the Kazakhstan government as represented by the Ministry of Energy and Mineral resources and the Company signed Agreement # 2 (state registration number 2272) on the introduction of changes and amendments to Contract # 40 dated 31 May 1996 on exploration and production of the Uzen and Karamandybas oil fields in the Mangistau oblast ("the Contract"). Agreement # 2 clarified certain aspects of the Contract's tax regime and also introduced the direct inclusion of social infrastructure obligations in the amount of up to KZT 900 million per year into the Contract.

Specifically, Agreement #2 has established clear excess profit tax calculation methodology, which was previously absent or lacking in the Contract. In prior periods the Company calculated and paid to the budget excess profit tax based on a conservative understanding of the Contract's provisions.

In accordance with the Agreement #2, the introduction of the specific excess profit tax calculation methodology was applied retrospectively from the Contract's inception date and resulted in a material decrease (18.6 billion Tenge) in the Company's prior years' excess profit tax liabilities. The effects of the change in the tax rate for the Contract have been fully reflected in the 2006 income tax expense.

In addition, Agreement #2 introduced certain changes that will be applied prospectively in the Company's financial statements. The Company's obligations on road use fund of 0.5% of turnover were abolished in exchange for an increase in royalty rate from 3% to 3.5%. Also, the social tax and value added tax rates were brought in line with the existing rates in current legislation. Other changes to the Contract were made in relation to smaller local taxes, which are not expected to have a material effect on the Company's financial statements.

As of December 31, 2006, total prepaid income taxes were 6.1 billion Tenge (2005: 4.1 billion Tenge).

# 19 Related party transactions

The category 'entities under common control' comprises entities of the Parents and all of those entities are state-controlled. Halyk Bank of Kazakhstan is a related party due to the bank being controlled by a member of the Parent Company's Board of Directors.

| | 2006 | 2005 |
|---|---|---|
| Sales of goods and services (Note 15) | | |
| Entities under common control | 321,037,075 | 260,878,868 |
| Parent Company | 3,856,643 | – |
| Associates | 16,217 | 8,965 |
| Purchases of goods and services (Note 16) | | |
| Entities under common control | 43,727,299 | 33,260,013 |
| Parent Company | 7,489,949 | 11,244,000 |
| Associates | 668,736 | 1,007,035 |
| Halyk Bank of Kazakhstan affiliates | 395,883 | – |
| Interest earned on financial assets | | |
| Halyk Bank of Kazakhstan | 1,204,307 | – |
| Average interest rate on deposits | 3.25% | – |
| Parent Company | 3,589,287 | – |
| Trade and other receivables (Note 9) | | |
| Entities under common control | 31,996,067 | 36,719,618 |
| Parent Company | – | 180,772 |
| Associates | 226 | 667,877 |
| Halyk Bank of Kazakhstan affiliates | 273,492 | – |
| Trade payables | | |
| Entities under common control | 1,725,051 | 1,128,480 |
| Parent Company | 2,114,180 | 408,124 |
| Associates | 293,088 | 129,324 |
| Loans receivable | | |
| Entities under common control | 94,185 | 3,639,487 |
| Parent Company (Note 9) | 100,786,068 | 9,000,000 |
| Loans payable (Note 13) | | |
| Parent Company | 5,720,113 | 5,840,833 |
| Financial assets (Note 9) | | |
| Halyk Bank of Kazakhstan | 26,085,624 | – |
| Cash and cash equivalents (Note 9) | | |
| Halyk Bank of Kazakhstan | 35,697,194 | – |
| Key management compensation | | |
| Salaries and other short-term benefits | 574,077 | 133,483 |
| Share-based payments | 31,276 | – |

*Sales and receivables*

Sales to related parties comprise mainly export and domestic sales of crude oil and oil products to KMG group entities. Export sales to related parties represented 4,972,199 tons of crude oil in 2006 (2005: 4,693,968 tons). The sales of crude oil are priced by reference to Platt's index quotations and adjusted for freight, insurance and quality differentials. For these exports of crude oil the Company received an average price per ton of approximately 55,430 Tenge in 2006 (2005: 47,837 Tenge). In addition, the Company supplies oil and oil products to the local market at the directive of the Kazakhstan government, the ultimate controlling shareholder of the Parent Company. These supplies to the domestic market represented 2,541,685 tons of crude oil production in 2006 (2005: 2,733,409 tons). Prices for the local market sales are determined by agreement with the distributors. For deliveries to the local market in 2006 the Company received an average price per produced crude oil ton of around 15,748 Tenge (2005: 13,288 Tenge). Trade and other receivables from related parties principally comprise amounts related to export sales transactions.

At December 31, 2006 the Company had commitments under a government directive to deliver 2.2 million tons of crude oil to local markets in 2007.

*Purchases and payables*
Management fees to the Parent Company amounted to 7,000,000 thousand Tenge in 2006 (2005: 11,244,000 thousand Tenge). Agency commissions for crude oil sales amounted to 678,179 thousand Tenge in 2006 (2005: 732,634 thousand Tenge). Transportation services related to the shipment of 7,649,026 tons of crude oil in 2006 (2005: 7,554,859 tons) were purchased from a KMG group entity for 32,024,409 thousand Tenge in 2006 (2005: 28,965,459 thousand Tenge). The remaining services purchased from Samruk group entities include primarily payments for demurrage, sales commissions and electricity.

*Loans and guarantees*
In 1996 a predecessor entity of the Company received from the Parent Company a facility of US $109,000 thousand for the rehabilitation of the Uzen oil field. Amounts drawn in 2006 totaled US $10,007 thousand (2005: US $2,633 thousand). The Company pays semi-annual installments of US $4,540 thousand through 2013 and a commitment charge of 0.75% per annum on the principal amount of the unutilized facility. This loan is secured by certain non-current assets of the Company (Note 20).

In 2006 the Company made an interest-free loan to the Parent Company in the amount of 24,371,325 thousand Tenge (2005: 26 billion Tenge), which was repaid in November 2006. The difference between the nominal value and the discounted amount of the loan has been recorded in equity.

# 20 Contingencies

*Operating environment*
The Kazakh economy, while deemed to be of market status beginning in 2002, continues to display certain characteristics consistent with that of an economy in transition. These characteristics have in the past included higher than normal historical inflation, lack of liquidity in the capital markets, and the existence of currency controls, which cause the national currency to be illiquid outside of Kazakhstan.

The Company's operations and financial position will continue to be affected by Kazakh political developments including the application of existing and future legislation and tax regulations. The Company does not believe that these contingencies, as related to its operations, are any more significant than those of similar enterprises in Kazakhstan.

*Local market obligation*
The Kazakhstan government requires oil producers to supply a portion of their crude oil production to meet domestic energy requirements (Note 19). While the price for such additional supplies of crude oil is agreed with the Company's Parent, this price may be materially below international market prices and may even be set at the cost of production. If the Government does require additional crude oil to be delivered over and above the quantities currently supplied by the Company, such supplies will take precedence over market sales and will generate substantially less revenue than crude oil sold on the export market, which may materially and adversely affect the Company's business, prospects, financial condition and results of operations.

*Taxation*
Kazakhstan's tax legislation and regulations are subject to ongoing changes and varying interpretations. Instances of inconsistent opinions between local, regional and national tax authorities are not unusual. The current regime of penalties and interest related to reported and discovered violations of Kazakhstan's tax laws are severe. Penalties are generally 50% of the taxes additionally assessed and interest is assessed at the refinancing rate established by the National Bank of Kazakhstan multiplied by 2.5. As a result, penalties and interest can amount to multiples of any assessed taxes. Fiscal periods remain open to review by tax authorities for five calendar years preceding the year of review. Under certain circumstances reviews may cover longer periods. Because of the uncertainties associated with Kazakhstan's tax system, the ultimate amount of taxes, penalties and interest, if any, may be in excess of the amount expensed to date and accrued at December 31, 2006. As at December 31, 2006 management believes that its interpretation of the relevant legislation is appropriate and that it is probable that the Company's tax positions will be sustained, except as provided for or otherwise disclosed in these financial statements (Notes 5 and 14).

*Environment*
The enforcement of environmental regulation in Kazakhstan is evolving and subject to ongoing changes. Penalties for violations of Kazakhstan's environmental laws can be severe. At year end 2005 the Company accrued fines of 11.4 billion Tenge for exceeding permitted norms at certain production sites. The Government linked the fines to the delayed submission by the Company of a remediation plan in accordance with the terms of a Memorandum of Understanding ("MOU") signed with the Company in mid-2005. Until the terms of the MOU are amended to extend the deadline specified therein, there can be no assurances that additional fines will not be assessed. Potential liabilities which may arise as a result of stricter enforcement of existing regulations, civil litigation or changes in legislation cannot be reasonably estimated. On July 7, 2006 the Specialized Inter-District Economic Court of the city of Astana ("SIDECA") decided the case in favor of the Company and fully dismissed the claim. On July 20, 2006, the Mangistau department of the MEP filed an appeal of the above court decision which was subsequently rejected by the Collegium on Civil Cases of the Astana City Court on August 9, 2006. The effect of the Collegium's rejection of the appeal is that the July 7 decision comes into force. Further to the August 9, 2006 decision the General Prosecutor's Office issued a supervisory protest with respect to the court judgment issued in favor of the Company on the payment of penalties for environmental damages. On November 16, 2006 the Supervisory Board of the Court

of Astana dismissed the supervisory protest and upheld the prior judgments made in favor of the Company. The Mangistau MEP can still ask the Supreme Court to reconsider the case as a whole and has until August 9, 2007 to do so. Following the favorable outcome of the SIDECA proceedings and the appeal court decision, management has released the accrual of 11.4 billion Tenge in 2006. Notwithstanding these developments, there can be no assurances that additional fines will not be assessed. Potential liabilities which may arise as a result of stricter enforcement of existing regulations, civil litigation or changes in legislation cannot be reasonably estimated. Other than those contingencies discussed here and obligations disclosed in Note 14, under existing legislation management believes that there are no probable or possible environmental liabilities which could have a material adverse effect on the Company's financial position, statement of income or cash flows.

*Legal proceedings*

During the year, the Company was involved in a number of court proceedings (both as a plaintiff and a defendant) arising in the ordinary course of business. There are no current legal proceedings or claims outstanding which management believes could have a material effect on the Company's financial position, statement of income or cash flows and which have not been accrued or disclosed in these financial statements.

*Oilfield licenses*

The Company is subject to periodic reviews of its activities by governmental authorities with respect to the requirements of its oilfield licenses and related subsoil use contracts. Management cooperates with governmental authorities to agree on remedial actions necessary to resolve any findings resulting from these reviews. Failure to comply with the terms of a license could result in fines, penalties, license limitation, suspension or revocation. The Company's management believes that any issues of non-compliance will be resolved through negotiations or corrective actions without any material effect on the Company's financial position, statement of income or cash flows.

The Company's oil and gas fields are located on land belonging to the Mangistau and Atyrau regional administrations. Licenses are issued by the Ministry of Energy and Mineral Resources of Kazakhstan and the Company pays royalties and excess profits tax to explore and produce oil and gas from these fields.

The principle licenses of the Company and their expiry dates are:

| Field | Contract No. | Expiry date |
|---|---:|---:|
| Uzen (8 fields) | 40 | 2021 |
| Emba (1 field) | 37 | 2021 |
| Emba (1 field) | 61 | 2017 |
| Emba (23 fields) | 211 | 2018 |
| Emba (15 fields) | 413 | 2020 |

Management believes that the Company will be successful in its attempts to extend its licenses beyond the initial expiration date under existing legislation where such extension is in the economic interest of the Company.

*Guarantees, pledges and covenants*

At December 31, 2006 the Company had collateralized non-current assets related to loans received in the amount of approximately 24 billion Tenge (2005: approximately 23 billion Tenge). Also, some of the Company's financing agreements require compliance with certain financial ratios and other terms. Non-compliance with such terms could result in long-term debt becoming callable by the creditor. At the end of each period presented management believes that the Company was in full compliance with all terms of such agreements.

# 21 Commitments

*Oilfield licenses and contracts*

| Year | Capital expenditures | Operational expenditures |
|---|---|---|
| 2007 | 24,362,706 | 4,510,761 |
| 2008 | 1,471,190 | 4,240,886 |
| 2009 | 858,000 | 3,875,761 |
| 2010 | 841,000 | 3,875,126 |
| 2011 | 841,000 | 3,875,126 |
| 2012-2021 | – | 30,377,170 |
| Total | 28,373,896 | 50,754,830 |

*Crude oil supply commitments*

Under the provisions of a pre-export financing agreement the Company has committed to deliver 150,000 tons of crude oil per month to the lender until September 2009 for fair value consideration determined at the date of shipment. The Company has further obligations to supply oil and oil products to the local market under government directives (Note 19).

# 22 Subsequent events

On March 5, 2007 the Company announced an agreement to purchase a 50% share of JV KazGerMunai from National Company KazMunaiGas (see Note 9) for cash consideration of 133.3 billion Tenge. The independent non-executive directors unanimously approved the purchase, which is subject to satisfaction of a number of conditions including the approval of a majority of non-controlling shareholders including GDR holders at an Extraordinary General Meeting scheduled for April 12, 2007 in Astana. If approved, the transaction is expected to close during the second quarter of 2007.

# Shareholder Information

## Annual General Meeting

The AGM will be held at 10:30 am, on May 18, 2007, at
The Rixos President Hotel,
1st floor, conference-hall "Shanyrak",
7, First str., Left Bank,
Astana, 010000,
Republic of Kazakhstan.

## Website

Information on the Company including details of activities, press releases and annual and interim reports is available at www.kmgep.kz.

## Shareholders' Enquiries

For information about proxy voting, dividends and to report changes in personal details, shareholders should contact the Company's registrar/ depositary:

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Holders of GDRs:
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NY 10286, United States of America
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Fax: +1 212 571 30 50
Telex: 62736 Western Union

## Number Of Shares In Issue

| | Common Shares | Preferred Shares | Total Share Capital [2] |
|---|---|---|---|
| Total number of shares issued [1] | 70,220,935 | 4,136,107 | 74,357,042 |

[1] Including 341,530 of treasury stock and 43,087,006 common shares or 61.36% owned by JSC NC KazMunaiGas. The information is provided as of the date of publishing the Annual Report.
[2] The Company's shares are listed on Kazakhstan Stock Exchange and the GDRs are listed on the London Stock Exchange. Each GDR corresponds to one sixth of an ordinary share.

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